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# Executory Contracts and Unexpired Leases in the Bankruptcy Code

Don Fogel

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Executory Contracts and Unexpired Leases in  
the Bankruptcy Code

Don Fogel\*

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## I. INTRODUCTION

Section 365(a) of the Bankruptcy Reform Act of 1978 (the Bankruptcy Code)<sup>1</sup> grants a trustee the power to assume or reject any executory contract or unexpired lease of the debtor.

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1. Pub. L. No. 95-598, 92 Stat. 2574 (to be codified at 11 U.S.C. § 365(a)). The Bankruptcy Reform Act of 1978 will hereinafter be referred to as either the Bankruptcy Code or the Code, and cited to section numbers only.

Congress created the Commission on the Bankruptcy Laws of the United States in 1970 to study and recommend changes in the Bankruptcy Act. Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468. The Commission submitted its final report to Congress in two sections. The first part reported the Commission's general findings and recommendations, and the second part presented a draft of a bill designed to implement those recommendations. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, pts. I & II, H.R. DOC. NO. 137, 93d Cong., 1st Sess. (1973) [hereinafter cited as BANKRUPTCY COMMISSION REPORT].

The Commission's draft was presented to Congress as H.R. 31, 94th Cong., 1st Sess. (1975), and as S. 236, 94th Cong., 1st Sess. (1975) [hereinafter cited as Commission's bill], reprinted in *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong., 1st & 2d Sess., ser. 27 (1975-1976) [hereinafter cited as *Hearings on H.R. 31 & H.R. 32*]. The National Conference of Bankruptcy Judges responded to the Commission's bill with a proposal of its own, which was introduced in Congress as H.R. 32, 94th Cong., 1st Sess. (1975), and as S. 235, 94th Cong., 1st Sess. (1975) [hereinafter cited as Judges' bill], reprinted in *Hearings on H.R. 31 & H.R. 32*, *supra*, app.

The bankruptcy reform bills underwent revision in the House, emerging finally as H.R. 8200, 95th Cong., 1st Sess. (1977). The House bill and its companion in the Senate, S. 2266, 95th Cong., 1st Sess. (1977), were the subject of hearings in the Senate and reports by both Houses. S. REP. NO. 989, 95th Cong., 2d Sess. (1978) [hereinafter cited as S. REP. NO. 989], reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5787; H.R. REP. NO. 595, 95th Cong., 1st Sess. (1977) [hereinafter cited as H.R. REP. NO. 595], reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963; *Bankruptcy Reform Act of 1978: Hearings on S. 2266 and H.R. 8200 Before the Senate Subcomm. on Improvements in Judicial Machinery of the*

The trustee's power, however, is subject to the court's approval and the limitations set forth in section 365.<sup>2</sup> This Article will explore those limitations and the trustee's rights and obligations when he assumes or rejects.

Section 554(a) of the Bankruptcy Code grants a trustee the power to abandon "property of the estate that is burdensome to the estate or that is of inconsequential value to the estate."<sup>3</sup> At common law, the trustee's power to reject executory contracts and unexpired leases grew out of his power to abandon burdensome property.<sup>4</sup> Burdensome executory contracts can be conceptualized as a class of property that the trustee can abandon.<sup>5</sup> Although Congress codified the trustee's power to reject contracts and leases in section 70(b) of the Bankruptcy Act in 1938,<sup>6</sup> Congress did not codify the trustee's power to abandon property until the enactment of section 554 in 1978.

The reasons for the separate treatment of the power to reject executory contracts and unexpired leases and the power to abandon burdensome property are not entirely clear. One commentator has suggested that Congress enacted section 70(b) of the Bankruptcy Act to benefit the nondebtor party to an executory contract or unexpired lease by requiring the trustee to decide whether to assume or reject within a fixed time.<sup>7</sup> This, however, does not explain why Congress delayed granting a

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*Senate Comm. on the Judiciary*, 95th Cong., 1st Sess. (1977) [hereinafter cited as *Hearings on S. 2266 & H.R. 8200*].

The House bill, H.R. 8200, and the Senate bill, S. 2266, differed slightly from each other and from the Bankruptcy Code as it was eventually passed. In place of a conference committee report, the legislative leaders in favor of the bill read substantially similar statements into the Congressional Record to explain the differences between the bills and the Code as it was passed. The explanatory statement of Representative Edwards appears in 124 CONG. REC. H11089 (daily ed. Sept. 28, 1978) [hereinafter cited as Statement of Rep. Edwards], reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6436. The statement of Senator DeConcini appears in 124 CONG. REC. S17406 (daily ed. Oct. 6, 1978) [hereinafter cited as Statement of Sen. DeConcini], reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6505.

2. Section 365(a) also states that sections 765 and 766 of the Bankruptcy Code limit the trustee's power to assume or reject; however, those sections, which deal with commodity broker liquidation, are beyond the scope of this Article.

3. Bankruptcy Code § 554(a).

4. See 2 COLLIER ON BANKRUPTCY ¶ 365.01[1] (15th ed. 1979); Silverstein, *Rejection of Executory Contracts in Bankruptcy and Reorganization*, 31 U. CHI. L. REV. 467, 468-69 (1964).

5. See Note, *Abandonment of Assets by a Trustee*, 53 COLUM. L. REV. 415, 417 (1953).

6. Act of June 22, 1938, ch. 575, § 70(b), 52 Stat. 840 (repealed 1978).

7. See Silverstein, *supra* note 4, at 473. See generally 2 COLLIER ON BANKRUPTCY ¶ 365.01[2] (15th ed. 1979). See also text accompanying note 103 *infra*.

similar benefit to a nondebtor party with an interest in property that the trustee might abandon.<sup>8</sup> Historical accident may best account for the separate statutory development and treatment of the power to reject and the power to abandon.

The Code, like the Bankruptcy Act, does not define the term "executory contract." The legislative history of the Code and the majority of cases decided under the Bankruptcy Act indicate that an executory contract is one in which neither side has fully performed at the commencement of bankruptcy. The House and Senate reports stated:

Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides. A note is not usually an executory contract if the only performance that remains is repayment. Performance on one side of the contract would have been completed and the contract is no longer executory.<sup>9</sup>

The Report of the Commission on the Bankruptcy Laws of the United States defined executory contracts with greater specificity by quoting Professor Countryman: "[A]n executory contract is one 'under which the obligation of the bankrupt and the other party to the contract is so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.'"<sup>10</sup> Several cases decided under the Bankruptcy Act also adopted Professor Countryman's definition of executory contracts.<sup>11</sup> Those cases under the Bankruptcy Act which held that a contract is executory if *either* party has not fully performed at the commencement of bankruptcy should be disregarded in view of the legislative history of the Code.<sup>12</sup>

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8. Under the Bankruptcy Code, a "party in interest" is allowed to request the court to "order the trustee to abandon any property that is burdensome to the estate or that is of inconsequential value to the estate." Bankruptcy Code § 554(b).

9. H.R. REP. NO. 595, *supra* note 1, at 347, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6303-04; S. REP. NO. 989, *supra* note 1, at 58, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5844.

10. BANKRUPTCY COMMISSION REPORT, *supra* note 1, pt. II, at 155 (quoting Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973)).

11. *See, e.g.*, *Chattanooga Mem. Park v. Still (In re Jolly)*, 574 F.2d 349, 352 (6th Cir.), *cert. denied*, 439 U.S. 929 (1978) (holding that a contract is not executory if it has already been breached by the debtor and reduced to final judgment; reasoning in part that the debtor has no future obligation to perform); *Northwest Airlines, Inc. v. Klinger (In re Knutson)*, 563 F.2d 916, 917 (8th Cir. 1977) (*per curiam*) (holding that an unused airline ticket for which the debtor has not paid is an executory contract).

12. *See, e.g.*, *Walsh v. Paterna (In re National Tile & Terrazzo Co.)*, 537 F.2d 329, 333 (9th Cir. 1976) (Goodwin, J., dissenting); *In re Teegarden*, 330 F. Supp. 1113, 1115 (E.D. Ky. 1971).

The trustee should reject executory contracts and unexpired leases when the estate would benefit through relief from burdensome obligations;<sup>13</sup> the trustee should assume executory contracts and unexpired leases that would "assist in the debtor's rehabilitation or liquidation."<sup>14</sup> A set of examples will show how the definition of executory contracts meshes with the trustee's objectives in deciding whether to assume or reject.

Assume that *B* contracts to buy one thousand bushels of corn from *S* at \$2.00 per bushel. One month later, on May 15, *B* files for bankruptcy. If *S* has already delivered the corn, the contract is no longer executory, and the trustee cannot reject *B*'s obligation under the contract. The trustee may be able to object to *S*'s claim against the estate, but *S*'s performance precludes the trustee's rejection of *B*'s correlative obligation to *S*. If *S* has not delivered by May 15, but *B* has paid, there is no executory contract for the trustee to assume. *S* has an obligation to deliver, and the trustee can sue for any breach of that obligation. Now assume that *B* has not paid for the corn by May 15, and *S* has not delivered by that date. Because neither party has fully performed, the contract is executory. The trustee's rejection could relieve the estate of a burdensome obligation, or the trustee's assumption could aid in rehabilitation. The market price of corn determines whether the trustee should assume or reject. If corn is selling at \$3.00 per bushel on May 15, the trustee should assume the contract and earn \$1,000 for the estate. If corn is selling at \$1.50 per bushel, the trustee should reject the contract to relieve the estate of the burdensome obligation of buying one thousand bushels of corn at fifty cents per bushel over the market price.<sup>15</sup>

This Article will set forth the important provisions of the law on executory contracts and unexpired leases in bankruptcy. The law has two components: the Bankruptcy Code and the common law developed under the Bankruptcy Act that is consistent with the Code. The first section of this Article explains the limitations on the trustee's power to assume or assign leases. These limitations arise in contracts and leases

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13. See *Jenson v. Continental Fin. Corp.*, 591 F.2d 477, 481 (8th Cir. 1979) (the power to reject executory contracts "is to be exercised in situations where the estate will be benefitted").

14. H.R. REP. NO. 595, *supra* note 1, at 348, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6304; S. REP. NO. 989, *supra* note 1, at 59, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5787, 5845.

15. See generally 2 COLLIER ON BANKRUPTCY ¶ 365.03 (15th ed. 1979).

terminated before bankruptcy, contracts and leases with bankruptcy clauses, contracts and leases that are nondelegable, contracts and leases in which there has been a default, and contracts and leases that the trustee intends to assign after assumption. The next section sets forth the trustee's rights and liabilities under executory contracts and unexpired leases. The subsections cover contracts and leases that the trustee has neither assumed nor rejected, contracts and leases that the trustee has assumed, and contracts and leases that the trustee has rejected. The final section discusses real property leases in which the debtor is the landlord and installment land sale contracts in which the nondebtor buyer is in possession. The Code singles out these contracts and leases for special treatment.

## II. LIMITATIONS ON THE TRUSTEE'S POWER TO ASSUME OR ASSIGN CERTAIN EXECUTORY CONTRACTS AND UNEXPIRED LEASES

### A. CONTRACTS AND LEASES TERMINATED BEFORE BANKRUPTCY

Generally, the trustee cannot assume a contract or lease that was validly terminated before bankruptcy under state or other applicable law.<sup>16</sup> For example, in *Allan v. Archer-Daniels-Midland Co. (In re Commodity Merchants, Inc.)*,<sup>17</sup> the debtor entered into four futures contracts<sup>18</sup> for the purchase of commodities. These contracts included clauses allowing the seller to terminate if the buyer's financial condition became "unsatisfactory."<sup>19</sup> The seller terminated the contracts under these clauses, and ten days later the buyer was adjudicated a bankrupt. The trustee then attempted to assume the contracts. The court held that, under state law, the termination clauses were valid and indicated that the seller had properly terminated the contracts. Accordingly, "[s]ince the contracts were no longer executory at the time of [the buyer's] bankruptcy, the bankruptcy trustee's purported assumption . . . was a nullity."<sup>20</sup>

The trustee, however, can sometimes set aside a prebank-

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16. See BANKRUPTCY COMMISSION REPORT, *supra* note 1, pt. II, at 156 ("an executory contract or unexpired lease terminated pursuant to a contractual provision or nonbankruptcy law prior to the date of the petition because of a default of the debtor cannot be assumed under [section 365]").

17. 538 F.2d 1260 (7th Cir. 1976).

18. Under these contracts, the debtor bought an option to purchase an amount of a commodity for a set price on a given future date.

19. 538 F.2d at 1262 n.1.

20. *Id.* at 1262. See *Chattanooga Mem. Park v. Still (In re Jolly)*, 574 F.2d 349, 352 (6th Cir.), *cert. denied*, 439 U.S. 929 (1978) (the executory contract provisions of the Bankruptcy Act do not apply to an installment sales contract for

ruptcy termination of a contract or lease as a fraudulent transfer. He can then assume the contract or lease as if it had not been terminated. In *Darby v. Atkinson (In re Ferris)*,<sup>21</sup> the landlord terminated the debtor's lease one week before bankruptcy because of the debtor's failure to pay rent. The court, applying state law, held that the landlord had properly terminated the lease;<sup>22</sup> but it then affirmed the bankruptcy judge's finding that the termination was a fraudulent transfer. The Court noted that, before the termination, the landlord received \$875 per month net from the leased property. After termination, the landlord received \$1,860 per month net and \$129,000 worth of improvements that the debtor had put into the property. In short, the termination was a fraudulent transfer because what the landlord "got by the termination far outweigh[ed] what he gave up. . . . [T]he lease was a good bargain and not a burdensome obligation [for the bankrupt tenant]." <sup>23</sup>

#### B. CONTRACTS AND LEASES WITH BANKRUPTCY CLAUSES

Bankruptcy clauses terminate or modify contracts or leases in the event of the bankruptcy of one party.<sup>24</sup> Contracting parties and landlords often add bankruptcy clauses to their agreements because they fear that the trustee, even if he assumes the contract or lease, will not provide them with the full benefit of the bargain they made with the debtor.<sup>25</sup> Under the Bank-

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the perpetual care of burial spaces that was breached by the debtor and reduced to judgment before the filing of the petition).

21. 415 F. Supp. 33 (W.D. Okla. 1976).

22. See *id.* at 39.

23. *Id.* at 41. Cf. *Allan v. Archer-Daniels-Midland Co. (In re Commodity Merchants, Inc.)*, 538 F.2d 1260, 1263-64 (7th Cir. 1976), discussed in text accompanying notes 17-20 *supra*, (holding that the seller's termination of commodity futures contracts did not transfer any of the debtor's property because the contracts did not have any market value).

24. Consider, for example, the following bankruptcy clause, drafted for a fast-food franchise agreement:

Licensor shall have the right to terminate this agreement upon notice in writing to Operator mailed to the above described premises upon the occurrence of any of the following events:

(a) Should Operator be declared insolvent or bankrupt, or make an assignment for the benefit of creditors, or in the event that a receiver is appointed or any proceeding is demanded by, for, or against Operator under any provision of the Federal Bankruptcy Act or any amendment thereof.

1A J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS, FORM 3.45, ¶ 17, at 3-2010 (1979).

25. The House and Senate reports explicitly recognized this fear, stating that "the courts will have to insure that the trustee's performance . . . gives the other contracting party the full benefit of his bargain." H.R. REP. NO. 595, *supra*



ruptcy Act, bankruptcy clauses could preclude the trustee's assumption of a contract or lease by terminating the agreement upon the filing of a bankruptcy petition.<sup>26</sup>

Section 365(e) of the Code invalidates bankruptcy clauses and any limitations they might otherwise place on the trustee's power to assume a contract or lease:

(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.<sup>27</sup>

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note 1, at 348, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6304-05; S. REP. NO. 989, *supra* note 1, at 59, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5787, 5845.

26. Bankruptcy clauses in contracts were enforceable under section 70b of the Bankruptcy Act. Act of June 22, 1938, ch. 575, § 70(b), 52 Stat. 840 (repealed 1978). See 2 COLLIER ON BANKRUPTCY ¶ 365.06 (15th ed. 1979). In leases, however, only express covenants terminating the agreement upon the filing of bankruptcy were enforceable. See *id.* The distinction between express and general covenants became blurred as courts sometimes exercised their equity powers to prevent the termination of leases necessary to the debtor's rehabilitation. Compare *In re D.H. Overmyer, Co.*, 510 F.2d 329 (2d Cir. 1975) with *Queens Boulevard Wine & Liquor Corp. v. Blum*, 503 F.2d 202 (2d Cir. 1974). See also *Commercial Trading Co. v. Lansburgh (In re Garfinkle)*, 577 F.2d 901 (5th Cir. 1978).

27. Bankruptcy Code § 365(e). The section continues:

(2) Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(ii) such party does not consent to such assumption or assignment; or

(B) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.

*Id.* Section 365(e)(2) gives precedence to section 365(c) over section 365(e)(1). Thus, if applicable law excuses the nonbankrupt party from rendering performance to or receiving performance from the trustee, the contract cannot be assumed without the nonbankrupt party's consent. See text accompanying note 37 *infra*. Section 365(e) must also be read in light of the statement that it does not limit the application of an ipso facto or bankruptcy clause if a new insolvency or receivership occurs after the bankruptcy case is closed. That is, the clause is not invalidated in toto, but merely made

Congress passed section 365(e) because bankruptcy clauses "frequently [hamper] rehabilitation efforts."<sup>28</sup> Under the Bankruptcy Act, lessors would often take advantage of a tenant who filed for rehabilitation by terminating the lease under a bankruptcy clause and then finding another tenant willing to pay higher rent.<sup>29</sup> Occasionally the lease termination would preclude any possibility of rehabilitation.

The fact that section 365(e) invalidates bankruptcy clauses in liquidation cases as well as rehabilitation cases indicates that Congress intended to deny the nonbankrupt party to an executory contract or unexpired lease any windfall from the fortuity of the debtor's bankruptcy. At the same time, if the nonbankrupt party made a good bargain with the debtor, the trustee can deny the nonbankrupt party the benefit of that bargain by rejecting the agreement. Assume, for example, that the executory contract for the sale of corn by *S* to *B* at \$2.00 per bushel has a bankruptcy clause. If the market price of corn rose to \$3.00 per bushel by the time of *B*'s bankruptcy, *S* could have reaped a windfall of \$1.00 per bushel under the Bankruptcy Act by terminating the contract. Under the Code, section 365(e) voids the bankruptcy clause and allows the trustee to preserve *B*'s good bargain for the benefit of the general creditors. If the price of corn fell to \$1.50 per bushel, both the Bankruptcy Act and the Code would allow the trustee to reject the agreement, leaving *S* with only a general claim for the benefit of his bargain.

The invalidation of bankruptcy clauses under the Code may affect negotiations between contracting parties. Landlords, for example, may demand higher rents because of the risk that the trustee will be an undesirable tenant.<sup>30</sup> Congress

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inapplicable during the case for the purposes of disposition of the executory contract or unexpired lease.

S. REP. NO. 989, *supra* note 1, at 59, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5845. The House Report contains a similar statement. *See* H.R. REP. NO. 595, *supra* note 1, at 349, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6305.

28. H.R. REP. NO. 595, *supra* note 1, at 348, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6305; S. REP. NO. 989, *supra* note 1, at 59, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5845. The invalidation of bankruptcy clauses is simply an application of the principle that the trustee takes title to the debtor's property upon bankruptcy. Under the Bankruptcy Act, bankruptcy clauses permitted the debtor to arrange in advance for the transfer, upon bankruptcy, of his interest in an executory contract or unexpired lease.

29. *See* Coogan, Broude & Glatt, *Comments on Some Reorganization Provisions of the Pending Bankruptcy Bills*, 30 BUS. LAW. 1149, 1179 (1975), *reprinted in Hearings on H.R. 31 & H.R. 32, supra* note 1, pt. I, at 399, 429.

30. *See Hearings on H.R. 31 & H.R. 32, supra* note 1, pt. III, at 1867; Note,

attempted to assuage the concerns of landlords and others in the Code's legislative history:

[Section 365(e)] will require the courts to be sensitive to the rights of the nondebtor party to executory contracts and unexpired leases. If the trustee is to assume a contract or lease, the court will have to insure that the trustee's performance under the contract or lease gives the other contracting party the full benefit of his bargain.<sup>31</sup>

This explanation directs the courts to withhold approval of the trustee's assumption of an agreement under section 365(a) if the trustee's likely performance will not give the nonbankrupt party the benefit of his bargain.

A party unwilling to assume the risk that the trustee's performance will fall short of his expectations can no longer protect himself with a bankruptcy clause. He can, however, protect himself by specifically defining the performance he expects of the debtor. The trustee must then perform accordingly.<sup>32</sup> For example, the royalty payments in franchise agreements and the rental payments in commercial leases often are set as a percentage of gross sales.<sup>33</sup> Under the Bankruptcy Act, the franchisor or lessor could use a bankruptcy clause to protect himself against a decline in royalty payments or rentals caused by reduced sales under the trustee's operation. Under the Code, the franchisor or lessor can protect himself by including an option to terminate the agreement if gross sales fall below a certain level,<sup>34</sup> or by setting royalty payments at the greater of a fixed amount or a percentage of sales.

A contracting party who cannot specifically define the performance he expects of the debtor can protect himself against the trustee's performance by including clauses that allow him

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*The Enforceability of Lease Forfeiture-Upon-Bankruptcy Covenants: A Proposal for Damages as an Alternative Remedy*, 49 S. CAL. L. REV. 339, 363 n.8 (1976).

31. H.R. REP. NO. 595, *supra* note 1, at 348, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6304-95; S. REP. NO. 989, *supra* note 1, at 59, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5845.

32. See text accompanying notes 92-93 *infra*.

33. This particular contractual arrangement was singled out in the House Report as one in which specified performance requirements would have to be considered by the court "in order to assure a landlord of his bargained for exchange." H.R. REP. NO. 595, *supra* note 1, at 348, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6305.

34. An illustration of such an option can be found in the franchise agreement quoted in note 24 *supra*, which included a clause giving the licensor an option to terminate "[s]hould the gross sales (upon which royalties are computed) . . . be less than \$200,000 during any calendar year commencing after the first year of operation." 1A J. RABKIN & M. JOHNSON, *supra* note 24, Form 3.45, ¶ 17(e), at 3-2011.

to terminate whenever bankruptcy is imminent.<sup>35</sup> If he polices his agreements and terminates them before the commencement of a case, there will be nothing left for the trustee to assume.<sup>36</sup> A nonbankrupt party who fails to terminate his agreement with the debtor before bankruptcy and who does not want to accept the trustee's performance must convince the court that the trustee will not produce the benefit of the nonbankrupt party's bargain with the debtor.

### C. NONDELEGABLE CONTRACTS AND LEASES

Although a nonbankrupt party cannot prevent the trustee's assumption or assignment after bankruptcy through a contract or lease clause, applicable law can prevent the trustee's assumption. Under section 365(c)(1) of the Code, the trustee cannot assume or assign a contract or lease if: (a) applicable law excuses the nonbankrupt party from accepting performance from or rendering performance to the trustee or an assignee, regardless of whether the contract or lease restricts assignment of rights or delegation of duties; and (b) the nonbankrupt party does not consent to the assumption or assignment of the agreement. This Article will refer to contracts and leases that the trustee cannot assume under section 365(c)(1) as "nondelegable."<sup>37</sup>

A contract for the performance of unique personal services is a nondelegable contract. Assume that a distinguished author contracts to write a book for a publisher, with payment due when the author submits his manuscript. If the author goes bankrupt before completing the manuscript, the trustee will not be able to assume or assign the contract. All writers do not "write dramas like Shakespeare or fiction like Dickens. Rare genius and extraordinary skill are not transferable, and contracts for their employment are therefore personal, and cannot

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35. For example, the commodity futures contracts in *Allan v. Archer-Daniels-Midland Co. (In re Commodity Merchants, Inc.)* included the following clause:

If Buyer's financial condition is found to be or becomes unsatisfactory to Seller during the term of this contract, Seller may terminate this contract and may also terminate all other contracts covering purchase by Buyer of Seller's products whether or not Buyer may otherwise be in default, and no rights shall accrue to Buyer against Seller on account of such termination.

538 F.2d at 1262 n.1, *discussed at* text accompanying notes 17-20 *supra*.

36. See text accompanying notes 16-20 *supra*.

37. Nondelegable contracts are also known as "personal contracts," a label which may be unfortunate and misleading." Countryman, *Executory Contracts in Bankruptcy: Part II*, 58 MINN. L. REV. 479, 482 (1974).

be assigned."<sup>38</sup>

The corn contract between *B* and *S* may also be nondelegable. Assume that while the contract is executory, *S* discovers that *B* is insolvent. Under section 2-702(1) of the Uniform Commercial Code, *S* can refuse delivery of the corn unless *B* pays cash.<sup>39</sup> If *B* files for bankruptcy and the trustee wants to assume the contract, *S* can still refuse delivery if the trustee will not pay cash. Section 2-702(1) is applicable law that, under section 365(c)(1) of the Bankruptcy Code, bars the trustee from compelling *S* to perform.

Whether section 2-609 of the U.C.C. would also be applicable law is a more complex question.<sup>40</sup> Section 2-609 gives a party to a contract who has reasonable grounds for insecurity about the other party's performance a right to demand "adequate assurance of due performance."<sup>41</sup> If the other party does not provide such assurance in thirty days, the party seeking assurance may treat the contract as terminated.<sup>42</sup> Assume that in the corn contract example, *B*'s bankruptcy would give *S* reasonable ground for insecurity and that the trustee does not respond to *S*'s demand for adequate assurance of performance. Section 2-609(4) deems the trustee's failure to assure a repudiation of the contract. This repudiation excuses *S* from rendering performance to the trustee, and section 365(c)(1) of the Bank-

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38. *Taylor v. Palmer*, 31 Cal. 240, 247 (1866), quoted in 4 A. CORBIN, CONTRACTS § 865, at 436 n.2 (1951).

39. "Where the seller discovers the buyer to be insolvent he may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery under this Article (Section 2-705)." U.C.C. § 2-702(1).

40. (1) A contract for sale imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either party the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return.

(2) Between merchants the reasonableness of grounds for insecurity and the adequacy of any assurance offered shall be determined according to commercial standards.

(3) Acceptance of any improper delivery or payment does not prejudice the aggrieved party's right to demand adequate assurance of future performance.

(4) After receipt of a justified demand failure to provide within a reasonable time not exceeding thirty days such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract.

U.C.C. § 2-609.

41. *Id.* For a definition of adequate assurance of performance, see text accompanying notes 61-67 *infra*.

42. See, e.g., *AMF, Inc. v. McDonald's Corp.*, 536 F.2d 1167 (7th Cir. 1976).

ruptcy Code prevents the trustee's assumption of the corn contract without *S*'s consent.<sup>43</sup>

But sections 365(b) and (f) of the Bankruptcy Code undercut this argument. In those sections, Congress required that adequate assurance of performance be provided if the trustee assumes a contract in which there had been a default<sup>44</sup> or if the trustee assigns any contract.<sup>45</sup> Since Congress did not expressly require the trustee to provide adequate assurance of performance for those contracts in which there is neither default nor assignment, perhaps Congress did not intend that section 365(c) would incorporate section 2-609 of the U.C.C. in such situations.<sup>46</sup>

Section 365(c) (2) of the Bankruptcy Code provides that the trustee cannot assume a "contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor."<sup>47</sup> Congress added this restriction on the trustee's power after several suggestions during the hearings that it was necessary "to preclude the preposterous situation of lending institutions being required to make loans to a bankrupt."<sup>48</sup> Section 365(c) (2) does not prevent the trustee from assuming contracts to deliver equipment to the debtor, ordinary leases, or contracts to provide goods or services with payments to be made over time.<sup>49</sup>

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43. The Bankruptcy Commission stated in its proposed draft that U.C.C. §§ 2-609 and 2-702 would be enforceable in liquidation, because applicable law could modify the debtor's contractual rights because of insolvency. These sections would not, however, be enforceable in rehabilitation cases, because applicable law cannot modify the debtor's contractual rights in such cases. BANKRUPTCY COMMISSION REPORT, *supra* note 1, pt. II, at 156. This statement, however, carries no force since the enacted version of section 365 of the Bankruptcy Code differs, in this context, from the Commission's bill.

44. Bankruptcy Code § 365(b)(1).

45. *Id.* § 365(f)(2)(B).

46. Professor Countryman concluded that, under the Bankruptcy Act, bankruptcy alone should not trigger U.C.C. § 2-609. Countryman, *supra* note 37, at 519-21. As indicated in the text, sections 365(b) and (f) support a similar interpretation of the Bankruptcy Code. U.C.C. § 2-609 was designed to meet the problem of anticipatory breach in "sales agreements looking to future performance." U.C.C. § 2-609, Official Comment 2. Sections 365(b) and (f) of the Bankruptcy Code, if they preclude application of U.C.C. § 2-609 in bankruptcy, also preclude any claim that bankruptcy alone is an anticipatory breach of a contract to which the U.C.C. does not apply.

47. Bankruptcy Code § 365(c)(2).

48. *Hearings on S. 2266 & H.R. 8200*, *supra* note 1, at 576 (statement of Robert J. Grimmer).

49. See Statement of Rep. Edwards, *supra* note 1, at H11093, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6436, 6446; Statement of Sen. DeConcini,

#### D. CONTRACTS AND LEASES IN WHICH THERE HAS BEEN A DEFAULT

Section 365(b) of the Bankruptcy Code requires the trustee to fulfill three conditions before he can assume a contract or lease in which there has been a default:

(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performances under such contract or lease.

(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to—

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.<sup>50</sup>

A default is, generally, a breach of a contract provision.<sup>51</sup> For the purposes of this Article, a "financial" default is a breach of a type described in section 365(b)(2).

The nondebtor party to a contract can terminate the agreement before bankruptcy because of a financial default.<sup>52</sup> Section 365(e)(1) applies only after bankruptcy to preclude termination or modification of a contract because of a financial default.<sup>53</sup> If a financial default occurs before bankruptcy and does not lead to termination, or if a financial default occurs after bankruptcy, the trustee does not, under section 365(b)(1), have to cure the default or compensate the nondebtor for losses caused by the default.<sup>54</sup>

A nonfinancial default before bankruptcy can terminate a

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*supra* note 1, at S17409, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6505, 6515.

50. Bankruptcy Code § 365(b).

51. See *Bass v. Foster*, 476 S.W.2d 181, 182 (Ky. 1972); *Dobitz v. Oakland*, 172 Mont. 126, 129, 561 P.2d 441, 442 (1977).

52. See, e.g., *Allan v. Archer-Daniels-Midland Co. (In re Commodity Merchants, Inc.)*, 538 F.2d 1260 (7th Cir. 1976), discussed in text accompanying notes 17-20 *supra*. Of course, any prebankruptcy termination could be a fraudulent transfer. See text accompanying notes 21-23 *supra*.

53. See text accompanying notes 24-36 *supra*.

54. Bankruptcy Code § 365(b)(1).

contract.<sup>55</sup> In many cases, however, a prebankruptcy nonfinancial default will not lead to a formal termination valid under state law. When the trustee attempts to assume the contract in such a case, he may, in addition to meeting the requirements of section 365(b)(1), have to overcome the argument that the contract is no longer executory because the prebankruptcy default was such a total breach that it suspended the nondebtor's obligation to perform. Because of the debtor's default, the nondebtor's failure to perform further would not be a material breach. Professor Countryman defined an executory contract as one in which the failure of either party to perform further would be a material breach.<sup>56</sup> Under that definition, this contract would not be executory. The trustee, therefore, would not be able to assume the contract, because section 365(a) only allows assumption of executory contracts. This argument applies the definition of executory contracts out of context. Professor Countryman's definition serves to distinguish executory contracts from claims of, or against, the estate.<sup>57</sup>

In deciding whether the trustee can assume a contract in which there has been a prebankruptcy material breach that did not lead to termination, a simple definition of executory contracts is not relevant. The balance that Congress struck between the rights of the nondebtor and those of the trustee is relevant. Section 365(b)(1) sets forth specific requirements that the trustee must meet in order to assume a contract in which there has been a nonfinancial default. The subsection apparently applies to prebankruptcy nonfinancial defaults.<sup>58</sup> Section 365(b)(1) also ensures that the nonbankrupt party will receive his expected return under the contract and that the nondebtor, as well as third parties, will receive compensation for pecuniary losses caused by the debtor's default. Congress recognized that the trustee would not always be able to compensate the nondebtor, and it is safe to assume that in these cases Congress intended to preclude the trustee's assumption of the contract.<sup>59</sup> The full provision under section 365(b)(1) for

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55. See, e.g., *Darby v. Atkinson (In re Ferris)*, 415 F. Supp. 33 (W.D. Okla. 1976), discussed in text accompanying notes 21-23 *supra*.

56. See Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

57. See text accompanying note 15 *supra*.

58. Compare Bankruptcy Code § 365(b)(1) with Bankruptcy Code § 365(e)(1). Section 365(e)(1) expressly applies only after commencement of bankruptcy.

59. "Where the rights of third parties are concerned, such as in the case of lease premises which have been rented to a third party, it is not intended



the rights of the nondebtor and third parties to an un-terminated contract on which the debtor has defaulted indicates that Congress did not intend a severe default amounting to a material breach to preclude the trustee's assumption of the contract.

To assume a contract in which there has been a nonfinancial default, under section 365(b)(1), the trustee must cure the default and compensate pecuniary losses caused by the default. Generally, this will be straightforward. If the debtor has missed one rent installment, the trustee can cure by paying that installment. If the landlord accelerates the remaining rent due under the lease before bankruptcy is filed, the trustee still only has to pay the one installment in order to assume the lease. Nonpayment of this installment was the debtor's only default. The landlord cannot maintain that the accelerated rent is compensation for pecuniary losses caused by the default. The trustee upon assumption will not be forced to pay the accelerated rent as an obligation of the debtor. Such a result would entirely vitiate the limitation on compensation for pecuniary losses.<sup>60</sup>

Rather than cure defaults and compensate losses caused by defaults, the trustee may instead provide adequate assurance of cure and compensation. The trustee must also provide adequate assurance of future performance. The discussion below will focus on the meaning of adequate assurance of future performance, but it should also help to clarify the meanings of adequate assurance of cure and compensation.

Congress has indicated that it imposed the requirement of adequate assurance "to insure that the trustee's performance under the contract of lease gives the other contracting party the full benefit of his bargain."<sup>61</sup> The Commission on the Bankruptcy Laws of the United States adopted the phrase "adequate

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that there will be adequate damages to compensate the third party." Statement of Rep. Edwards, *supra* note 1, at H11103, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6436, 6472; Statement of Sen. DeConcini, *supra* note 1, at S17420, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6505, 6541.

60. *Cf.* Bankruptcy Code § 1124(2) (allowing the trustee to reverse acceleration of a claim by reinstating its maturity if the plan cures any nonfinancial default and compensates for damages caused by the default).

61. H.R. REP. NO. 595, *supra* note 1, at 348, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6304-05; S. REP. NO. 989, *supra* note 1, at 59, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5845. Although the quoted text does not directly refer to the adequate assurance language of section 365(b)(1), the House Report continues with a discussion of the bargain made by a shopping center lessor, and with the definition of adequate assurance for a shopping center lease under section 365(b)(3).

assurance of future performance" from section 2-609 of the Uniform Commercial Code.<sup>62</sup> The Commission stated:

What constitutes . . . "adequate assurance of future performance" must be determined by consideration of the facts of the proposed assumption. Cf. Official Comment 4 to Uniform Commercial Code § 2-609 (1972 ed.). It is not intended, however, that any nondebtor party should acquire greater rights in a case under the Act than he has outside the Act.<sup>63</sup>

The meaning of "adequate assurance of due performance" in section 2-609 of the U.C.C. should approximate the meaning of "adequate assurance of future performance" in section 365(b)(1) of the Bankruptcy Code. In section 2-609 of the U.C.C., one party demands adequate assurance of performance because he does not want to perform until he is reasonably certain that the other party will perform. In section 365(b)(1) of the Bankruptcy Code, the nonbankrupt party is uncertain whether the trustee will perform a contract in which there has already been a default, and he does not want to perform without being reasonably certain that the trustee will fully perform after assumption.

Official Comment 4 to section 2-609 of the U.C.C. provides an example of adequate assurance of performance in a case prior to the enactment of the U.C.C., *Corn Products Refining Co. v. Fasola*.<sup>64</sup> The Corn Products Refining Company demanded security that Fasola would pay for goods he had ordered, after he failed to pay soon enough to qualify for an early discount, for which he had qualified in all prior transactions. Fasola sent a good credit report from his banker and said he would make the payments when they were due. This, according to the Comment, was adequate assurance of performance. A trustee who showed the court that he had adequate cash to pay a supplier and promised to pay the supplier could cite *Corn Products Refining Co.* and Official Comment 4 to support his assertion that he had furnished adequate assurance of performance under section 365(b)(1) of the Bankruptcy Code.

Other cases decided under section 2-609 of the U.C.C. indicate that adequate assurance of performance can require a deposit in escrow to secure payment,<sup>65</sup> a set of quantitative performance standards,<sup>66</sup> or a certificate from a third party as-

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62. See BANKRUPTCY COMMISSION REPORT, *supra* note 1, pt. II, at 156.

63. *Id.* at 156-57.

64. 94 N.J.L. 181, 109 A. 505 (1920).

65. See, e.g., *Kunian v. Development Corp.*, 165 Conn. 300, 312, 334 A.2d 427, 433 (1973) (deposit in escrow required after buyer repeatedly broke promises to pay for deliveries).

66. See, e.g., *AMF, Inc. v. McDonald's Corp.*, 536 F.2d 1167, 1171 (7th Cir.

sureing the contracting party's performance.<sup>67</sup>

The parties to a contract can also define adequate assurance of performance in advance for the purposes of section 2-609.<sup>68</sup> For example, the court in *Northwest Lumber Sales, Inc. v. Continental Forest Products, Inc.*,<sup>69</sup> held that the parties had contractually stipulated that a guarantee of payment would be adequate assurance of performance. This result suggests that contracting parties may be allowed to define adequate assurance in order to minimize the chance that a bankruptcy court will apply what the parties view as an inaccurate definition of adequate assurance. This contractual definition of adequate assurance could be used under section 2-609 if bankruptcy did not occur, under section 2-609 applied to the trustee through section 365(c)(1) of the Bankruptcy Code, or under section 365(b)(1) of the Bankruptcy Code. But a contractual definition of adequate assurance for the purpose of section 365(b)(1) might fall within section 365(e)(1), which voids any provision that modifies a contract or lease because of the debtor's financial position.<sup>70</sup> Even if a contract definition would not bind a court, many courts may respect a definition of adequate assurance agreed upon in advance by contracting parties with equal bargaining power.

In section 365(b)(3), the Bankruptcy Code expressly defines adequate assurance of future performance of a lease of real property in a shopping center:

For the purposes of paragraph (1) of this section, adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance—

- (A) of the source of rent and other consideration due under such lease;
- (B) that any percentage rent due under such lease will not decline substantially;
- (C) that assumption or assignment of such lease will not

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1976) (adequate assurance of performance of computerized cash registers for "fast food" restaurants defined as promises of certain failure rates, downtimes, and service costs for the registers).

67. See, e.g., *Appeal of Productions Unlimited*, 3 U.C.C. REP. SERV. 620, 627 (Veterans Admin. Contract App. Bd. No. 541, Mar. 11, 1966) (adequate assurance of contract provisions that films licensed to Veterans Administration not be shown on television over the period of the license required a certificate to that effect from the holder of the television rights). See also Note, *A Right to Adequate Assurance of Performance in All Transactions: U.C.C. §2-609 Beyond Sales of Goods*, 48 S. CAL. L. REV. 1358, 1369-72 (1975).

68. See U.C.C. § 1-102(3); Taylor, *The Impact of Article 2 of the U.C.C. on the Doctrine of Anticipatory Repudiation*, 9 B.C. INDUS. & COM. L. REV. 917, 925 (1968).

69. 261 Or. 480, 495 P.2d 744 (1972).

70. See text accompanying note 27 *supra*.

breach substantially any provision, such as a radius, location, use, or exclusivity provision, in any other lease, financing agreement, or master agreement relating to such shopping center; and

(D) that assumption or assignment of such lease will not disrupt substantially any tenant mix or balance in such shopping center.<sup>71</sup>

The House Report stated:

A shopping center is often a carefully planned enterprise, and though it consists of numerous individual tenants, the center is planned as a single unit, often subject to a master lease or financing agreement. Under these agreements, the tenant mix in a shopping center may be as important to the lessor as the actual promised rental payments, because certain mixes will attract higher patronage of the stores in the center, and thus a higher rental for the landlord from those stores that are subject to a percentage of gross receipts rental agreement.<sup>72</sup>

Congress specifically defined adequate assurance of future performance of a shopping center lease in which there has been a nonfinancial default, but it entrusted the courts with the definition of adequate assurance of the performance of contracts and other leases. As indicated above, the unenforceability of bankruptcy clauses requires the court to ensure that the trustee, after assumption, will provide the nonbankrupt party with the benefit of his bargain.<sup>73</sup> The complexity of shopping center leases and the risk that, because of that complexity, courts might not ensure the nonbankrupt lessor the benefit of his bargain, led Congress to enumerate the factors constituting adequate assurance of performance of a shopping center lease.<sup>74</sup> The several requests in the hearings for special protection for shopping center lessors<sup>75</sup> and the abundance of shopping centers may also have contributed to Congress' enactment of section 365(b)(3).<sup>76</sup>

The House Report defined a shopping center as a carefully planned retail enterprise that functions as a single unit even though it has numerous individual tenants.<sup>77</sup> Consider a thirty-

71. Bankruptcy Code § 365(b)(3).

72. H.R. REP. NO. 595, *supra* note 1, at 348, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6305. *See Hearings on S. 2266 & H.R. 8200, supra* note 1, at 723 (statement of Sylvan M. Cohen) (A shopping center is "a group of retail stores and related business facilities, the whole planned, developed, operated, and managed as a unit.") (source not cited).

73. *See* text accompanying note 31 *supra*.

74. *See* H.R. REP. NO. 595, *supra* note 1, at 348-49, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6305.

75. *See, e.g., Hearings on S. 2266 & H.R. 8200, supra* note 1, at 706 (statement of Edward J. Kulik); *id.* at 726 (statement of Sylvan M. Cohen); *Hearings on H.R. 31 & H.R. 32, supra* note 1, pt. III, at 1853-54.

76. *See generally Hearings on S. 2266 & H.R. 8200, supra* note 1, at 723 (statement of Sylvan M. Cohen) (In 1976, 17,523 shopping centers accounted for 36% of all retail trade.).

77. *See* text accompanying note 72 *supra*.

story office building with the ground floor leased by a number of retail stores and the upper floors leased by a variety of firms for business offices. If an office supply company defaults on its lease of a bottom floor store and then files for bankruptcy, the trustee may have to meet the rigid requirements of section 365(b)(3) before he can assume the lease. In order to impose those requirements on the trustee, the lessor must take the position that the bottom floor of the office building is a shopping center because it consists of numerous retail stores that function together as a unit to provide services and supplies for the tenants on the upper floors. The trustee, however, can argue that the office supply store is not in a shopping center. The Senate Report, discussing a predecessor of section 365(b)(3), distinguished between "lease situations common to shopping centers" and "office building situation[s]," stating that "protection for [the] tenant mix will not be required in the office building situation."<sup>78</sup> Furthermore, the bottom floor does not function as an independent unit, but only as a component part of the building. This example suggests that the trustee may frequently litigate the definition of "shopping center."

#### E. CONTRACTS AND LEASES THAT THE TRUSTEE INTENDS TO ASSIGN AFTER ASSUMPTION

Section 365(f)(1) invalidates provisions in executory contracts, unexpired leases, and applicable law that prohibit, restrict, or condition assignment. Subsection (2) provides that the trustee can assign an executory contract or unexpired lease only if he assumes in accordance with the provisions of section 365 and if adequate assurance of future performance of the contract or lease "is provided." Section 365(f)(3) states that contracts and leases cannot be terminated or modified by contractual provisions or by applicable law because of assumption or assignment by the trustee.<sup>79</sup>

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78. S. REP. NO. 989, *supra* note 1, at 59, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5787, 5845.

79. Section 365(f) of the Bankruptcy Code states:

(1) Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.

(2) The trustee may assign an executory contract or unexpired lease of the debtor only if—

(A) the trustee assumes such contract or lease in accordance with the provisions of this section; and

(B) adequate assurance of future performance by the as-

Under section 365(c)(1), a trustee cannot assume certain executory contracts and unexpired leases because applicable law excuses the nonbankrupt party from rendering performance to or receiving performance from the trustee. Section 365(f)(2)(A) requires the trustee to assume an executory con-

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signee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

(3) Notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law that terminates or modifies, or permits a party other than the debtor to terminate or modify, such contract or lease or a right or obligation under such contract or lease on account of an assignment of such contract or lease, such contract, lease, right, or obligation may be terminated or modified under such provision because of the assumption or assignment of such contract or lease by the trustee.

Section 365(f)(3), perhaps the most confusing paragraph of this section, appears to add nothing to section 365(f)(1). Any clause that terminates or modifies a contract or lease because of the trustee's assignment effectively prohibits assignment. Although section 365(f)(1) is subject to the restrictions of section 365(c), section 365(f)(3) is not.

Section 365(f)(3) also appears to conflict with section 365(c). Paragraph (3) states that no executory contract or unexpired lease may be terminated or modified because of a provision in applicable law that allows or provides for termination or modification upon assumption or assignment. Under section 365(c), however, the trustee cannot assume if applicable law excuses the nonbankrupt party from rendering performance. In certain situations, section 365(c) may therefore operate to nullify section 365(f)(3). Applicable law cannot terminate the contract or lease because of section 365(f)(3). Section 365(c), however, prevents the trustee from assuming certain contracts, and if he cannot assume, termination of the contract is irrelevant to the trustee.

This interpretation of the relationship between sections 365(c) and 365(f)(3) could completely undercut Congress' purpose in enacting section 365(f). Assume the landlords in a state convince their legislature to pass a law that provides that no lease can be assigned without the consent of the landlord. A landlord whose lease the trustee wants to assume can claim that his lease is nondelegable under section 365(c) and that, therefore, the trustee cannot assume it. This area of the law needs clarification, perhaps through a technical amendment reconciling sections 365(c) and 365(f)(3), to prevent frustration of the policy embodied in section 365(f)(3). In this hypothetical context, the court can enforce the policy behind section 365(f)(3) by exercising its equitable powers to override section 365(c).

The Congressional Record contains an obscure statement that does little to resolve this controversy:

Section 365(f) is derived from H.R. 8200 as passed by the House. Deletion of language in section 365(f)(3) of the Senate amendment [S. 2266] is done as a matter of style. Restrictions with respect to assignment of an executory contract or unexpired lease are superfluous since the debtor may assign an executory contract or unexpired lease of the debtor only if such contract is first assumed under section 365(f)(2)(A) of the House amendment.

Statement of Sen. DeConcini, *supra* note 1, at S17410, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6505, 6515-16; Statement of Rep. Edwards, *supra* note 1, at H11093, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6436, 6447. One might infer from this statement that Congress intended to delete section 365(f)(3) from the Code. But Congress did not delete it. Furthermore, section 365(f) is the same in the Code, in H.R. 8200, and in S. 2266.

tract or unexpired lease in accordance with the other provisions of section 365 before assigning it. The trustee, therefore, cannot assign any executory contract or unexpired lease that he cannot assume under section 365(c)(1). The trustee cannot assign an executory contract to make a loan because section 365(c)(2) forbids the assumption of such a contract. Nor can the trustee assign a contract that he did not assume within the time limits set by section 365(d).<sup>80</sup> Furthermore, if there has been a nonfinancial default in an executory contract or unexpired lease, the trustee cannot assign without first curing the default, compensating the nonbankrupt party for any actual pecuniary loss caused by the default, and providing adequate assurance of future performance.<sup>81</sup>

Even if there has not been a default in an executory contract or unexpired lease, the trustee can assign only if "adequate assurance of future performance by the assignee . . . is provided."<sup>82</sup> By using the passive voice, the statute fails to make clear whether the trustee or the assignee must provide adequate assurance. Section 365(k) of the Bankruptcy Code, however, clearly relieves the trustee and the estate from any liability for a breach occurring after the assignment of a contract or lease.<sup>83</sup> Thus, if the court allows assignment of an executory contract or unexpired lease, the trustee and the estate are free from liability for any breach by the assignee, regardless of whether the court relied on assurance of performance from the trustee or the assignee.

The legislative history of the Code does not speak to the definition of "adequate assurance of future performance" in section 365(f). The definition should generally be the same as in section 365(b).<sup>84</sup> The definition of adequate assurance of future performance of a lease of real property in a shopping

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80. Section 365(d)(1) of the Bankruptcy Code provides:

In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease is deemed rejected.

For further discussion of section 365(d), see text accompanying notes 99-103 *infra*.

81. Bankruptcy Code § 365(b)(1). See text accompanying notes 50-70 *supra*.

82. Bankruptcy Code § 365(f)(2)(B).

83. Section 365(k) of the Bankruptcy Code provides: "Assignment by the trustee to an entity of a contract or lease assumed under this section relieves the trustee and the estate from any liability for any breach of such contract or lease occurring after such assignment."

84. See text accompanying notes 61-70 *supra*.

center, provided in section 365(b)(3), however, does not expressly apply to an assignment of such a lease when there has not been a default.<sup>85</sup>

The Bankruptcy Act, in section 70(b), invalidated only general lease provisions restricting assignment.<sup>86</sup> Express lease provisions restricting assignment and all executory contract provisions, express or general, restricting assignment were valid. Section 70(b) allowed contracting parties to protect themselves against the trustee's imposition of an undesirable assignee. At the same time, it often frustrated the trustee's attempts to acquire for the estate the benefit of the debtor's good bargain.<sup>87</sup>

The extent to which parties will be able to protect themselves against undesirable assignees under current law will depend on how the courts balance the conflicting dictates of section 365(f): adequate assurance of future performance must be provided and provisions restricting assignment are invalid. Consider again the thirty-story office building with its bottom floor leased to a number of retail establishments that will serve the needs of the tenants of the upper floors.<sup>88</sup> Assume that in each retail lease a clause provides that the tenant must operate a particular type of business. One tenant, the office supply company, goes bankrupt without defaulting on its lease. If the trustee assigns the lease to an office supply company, the lessor has no complaint. But assume the trustee cannot find any potential assignee other than a massage parlor. The lessor fears that having a massage parlor as a highly visible tenant will offend the other tenants and reduce the rental value of the building. Accordingly, he moves to block the trustee's assignment.

The lessor should first attempt to convince the court that the office supply company occupied a store in a shopping center.<sup>89</sup> If the lessor succeeds with that argument, he must

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85. See generally text accompanying notes 71-73 *supra*.

86. See 4A COLLIER ON BANKRUPTCY ¶ 70.43 (14th ed. 1978).

87. Reconsider the executory contract for the sale of corn discussed in the text following note 29 *supra*. Assume that this contract had a clause providing for termination upon assignment as well as a bankruptcy clause. Section 365(b) invalidates the bankruptcy clause, and section 365(f)(1) invalidates the antiassignment clause. Thus, under the Bankruptcy Code, the trustee can assume and then assign the contract to preserve for the estate the benefit of the debtor's good bargain. Under the Bankruptcy Act, the trustee could have neither assumed nor assigned the contract.

88. See text accompanying notes 77-78 *supra*.

89. *Id.*



then convince the court that the section 365(b)(3) definition of adequate assurance of performance of a shopping center lease in which there has been a default also applies to the adequate assurance called for by section 365(f)(2)(B) in the absence of a default.<sup>90</sup> The court, if it accepts both of the lessor's arguments, will prohibit the trustee's assignment to the massage parlor because it would "disrupt substantially [the] tenant mix [of the] shopping center."<sup>91</sup>

If the court holds that the office supply company is not in a shopping center despite the fact that it occupies the building's ground floor along with a number of other retail establishments, the lessor must argue that the operation of an office supply company is an element of performance in the lease, and that he is therefore due adequate assurance of performance of that portion of the lease obligation. To this argument the trustee has two responses. First, the lessor is seeking to protect his tenant mix with the lease provision, and the Code does not require the court to provide such protection.<sup>92</sup> Second, the lease provision restricting the use of the premises to office supply companies invalidly conditions assignment under section 365(f)(1) in the same manner as would a provision allowing assignment only to an office supply company.

The trustee has the stronger position here. The lessor of the office building, however, could protect himself from undesirable assignees by drafting his leases and monitoring his tenants' operations so that he could terminate a lease when a tenant's bankruptcy was imminent. This scheme would leave nothing for the trustee to assume or assign.<sup>93</sup> Of course, this would not be a practical solution for many lessors; but if enough landlords were to terminate leases before their tenants went bankrupt, Congress might change the law to allow reasonable restrictions on assignments to provide landlords with some protection against undesirable assignees. Moreover, landlords could argue to courts that interpreting the Code to invalidate lease provisions like the one in the example would encourage prebankruptcy terminations, thereby forcing financially insecure tenants into bankruptcy.

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90. See text accompanying notes 84-85 *supra*.

91. Bankruptcy Code § 365(b)(3)(D).

92. See text accompanying note 78 *supra*.

93. See text accompanying notes 32-36 *supra* (discussing prebankruptcy termination of executory contracts and unexpired leases that does not run afoul of the invalidation of bankruptcy clauses in section 365(e) of the Bankruptcy Code). See also text accompanying notes 21-23 *supra* (discussing when a prebankruptcy lease termination amounts to a fraudulent transfer).

### III. THE TRUSTEE'S RIGHTS AND LIABILITIES IN EXECUTORY CONTRACTS AND UNEXPIRED LEASES

#### A. CONTRACTS AND LEASES THAT THE TRUSTEE HAS NOT ASSUMED OR REJECTED

##### 1. *Preservation of the Status Quo While the Trustee Decides Whether to Assume or Reject*

The trustee will usually take some time after his appointment to decide which of the debtor's executory contracts and unexpired leases he should reject because they are burdensome to the estate and which he should assume because they will benefit the estate. While the trustee is deciding whether to assume a contract or lease, the nondebtor party may attempt to terminate the agreement to prevent the trustee's assumption. The provision for an automatic stay in section 362(a)<sup>94</sup> of the Bankruptcy Code will prevent any immediate, ex parte termination of a contract or lease by the nondebtor party. Under section 362(d), however, the nondebtor party can seek relief from the stay, to allow it to terminate the contract or lease.<sup>95</sup> In this context, the court should consider that one reason Congress singled out executory contracts and unexpired leases for special treatment in section 70b of the Bankruptcy Act was to ensure that the nondebtor would know within a limited time whether the trustee would assume and compel his performance.<sup>96</sup> The court should preserve the status quo between the trustee and the nondebtor for a reasonable time to give the trustee an opportunity to decide whether to assume or reject

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94. Section 362(a) of the Bankruptcy Code provides that "a petition filed under . . . this title operates as a stay, applicable to all entities, of . . . (3) any act to obtain possession of property of the estate or of property from the estate." An executory contract or unexpired lease of the debtor is property of the estate. See text accompanying notes 4-5 *supra*. See also *Darby v. Atkinson (In re Ferris)*, 415 F. Supp. 33 (W.D. Okla. 1976), discussed in text accompanying notes 21-23 *supra*. Termination of a contract or lease of the debtor, therefore, is an act to "obtain possession of property of the estate."

95. Section 362(d) of the Bankruptcy Code provides:

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(2) . . . with respect to a stay of an act against property, if—  
(A) the debtor does not have an equity in such property; and  
(B) such property is not necessary to an effective reorganization.

96. See text accompanying note 7 *supra*.

an executory contract or unexpired lease.<sup>97</sup> The trustee's right to a reasonable time for decision is "paramount to the other party's right . . . to claim a forfeiture, as in a lease, because of nonperformance by the trustee."<sup>98</sup>

In liquidation cases, the Code defines sixty days after the order for relief as the reasonable time within which the trustee must decide to assume or reject.<sup>99</sup> The court, for cause, can extend the sixty-day period to give the trustee additional time to decide.<sup>100</sup> If the trustee's assumption of an executory contract or unexpired lease is not timely, section 365(d)(1) deems the contract or lease rejected.

Section 365(d)(2) does not specify a time within which the trustee must assume a contract or lease in cases arising under chapters 9, 11, or 13.<sup>101</sup> It does, however, allow the court, "on request of any party to [a] contract or lease, [to] order the trustee to determine within a specified period of time whether to assume or reject."<sup>102</sup> The legislative history explains, "This provision will prevent parties in contractual or lease relationships with the debtor from being left in doubt concerning their status vis-a-vis the estate."<sup>103</sup> The courts may not always be able to effect the intent of Congress expressed in this quote. Consider, for example, a debtor who operates a chain of supermarkets on leased property in several states. When the debtor files for rehabilitation, several creditors that have made large loans to the debtor insist that it limit its operations to one state. The debtor wants to continue its widespread operations.

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97. See *Thompson v. Texas Mexican Ry.*, 328 U.S. 134, 151 (1946).

98. *Bradshaw v. Loveless (In re American Nat'l Trust)*, 426 F.2d 1059, 1064 (7th Cir. 1970) (quoting 6 COLLIER ON BANKRUPTCY ¶ 3.23, at 576-80 (14th ed. 1978)).

99. Bankruptcy Code § 365(d)(1), *quoted in* note 80 *supra*.

100. *Id.*

101. Section 365(d)(2) of the Bankruptcy Code states:

In a case under chapter 9, 11, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of the debtor at any time before the confirmation of a plan, but the court, on request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.

See also Bankruptcy Code §§ 1123(b)(2), 1322(b)(7) (allowing the plan of reorganization to provide for the assumption or rejection of an executory contract or unexpired lease that the trustee has not previously rejected under section 365).

102. *Id.* § 365(d)(2).

103. H.R. REP. NO. 595, *supra* note 1, at 348, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6304; S. REP. NO. 989, *supra* note 1, at 59, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5845. See also text accompanying note 7 *supra*.

For the possibly lengthy time during which the debtor and the creditors wrangle over the plan, the lessors of the supermarkets that the debtor may have to abandon under the plan will not know whether the debtor will assume or reject their leases.<sup>104</sup>

As discussed above, the nondebtor party to a contract or lease may attempt to terminate under a default clause while the trustee, or debtor in possession, decides whether to assume or reject.<sup>105</sup> Several cases have explored the powers of the court to preserve the status quo during the trustee's decision period.

In *P.M.G. Corp. v. Hogan (In re Gulfco Investment Corp.)*,<sup>106</sup> the debtor filed for reorganization on April 1, 1974. On June 28, the trustee successfully moved for a postponement of the decision on the assumption of an executory land sale contract to give his deputy time to evaluate the contract. The trustee failed to make the installment payment due under the contract on July 1 and, on August 1, the nondebtor party purported to terminate the contract under a default clause allowing termination after a failure to pay for thirty days. The court denied the nondebtor party the benefit of the default clause and later allowed the trustee to assume the contract. The court stated that it had "the power to preserve the status quo while the trustee is utilizing the reasonable period of time to make up his mind" whether to assume.<sup>107</sup> The value of the land in *P.M.G. Corp.* was "apparently rising,"<sup>108</sup> and the debtor had already made substantial installment payments. Equity, therefore, dictated that the nondebtor party should not be allowed to terminate the contract and deny the benefit of the debtor's good bargain to the estate. The court found that "[t]he countervailing equities [were] not impaired because if the trustee decide[d] to adopt the contract, it [would] have to make the payments it [had] missed with interest."<sup>109</sup>

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104. See Bankruptcy Code §§ 1101(1), 1107(a) (granting the "debtor in possession" the powers of the trustee, including the power to assume or reject executory contracts and unexpired leases under section 365).

105. See text accompanying notes 51-55 *supra*.

106. 520 F.2d 741 (10th Cir. 1975).

107. *Id.* at 743.

108. *Id.* at 744.

109. *Id.* The court here requires the trustee to cure the default and compensate the nondebtor for the pecuniary loss caused by the default. The Code also requires cure of and compensation for defaults before assumption. See Bankruptcy Code § 365(b) (1) (A)-(B), discussed in text accompanying notes 51-60 *supra*.

In *Schokbeton Industries, Inc. v. Schokbeton Products Corp.*,<sup>110</sup> the nondebtor party granted an exclusive franchise of an innovative concrete manufacturing process to the debtor. The license agreement obligated the debtor to pay royalties and allowed the licensor the option of terminating the agreement sixty days after sending notice to the licensee of its default in royalty payments. The licensor sent such notice on November 13, 1970; the debtor filed for bankruptcy on December 8, 1970; and on January 16, 1971, when the default continued, the nondebtor purportedly terminated the license. More than four months later, the debtor successfully petitioned the bankruptcy judge to enjoin the licensor's grant of the debtor's exclusive franchise to another licensee. The referee stated that the default would be cured "during an extended period as may be determined by this Court."<sup>111</sup>

On appeal, the Court of Appeals for the Fifth Circuit framed one issue as whether "the concededly pervasive authority of the referee permit[ted] him to preserve [the] Debtor's contractual rights by indefinitely postponing the performance required by the terms of the contract (i. e. the payment of past due royalties)."<sup>112</sup> The court found that no specific provision of the Bankruptcy Act empowered the referee to suspend a forfeiture provision unilaterally.<sup>113</sup> The Fifth Circuit acknowledged that loss of the franchise would cause the debtor irreparable injury, but it then stated:

We conclude that this is simply not a case for the invocation of high equity. [The licensor's] contractual right to terminate the contract clearly survived both the filing of the arrangement petition and the [bankruptcy judge's] belated attempt to resurrect an already moribund agreement. In such circumstances [the] Debtor must live with its forfeiture.<sup>114</sup>

*P.M.G. Corp.* distinguished *Schokbeton Industries* on the ground that it did not address the question of restraining forfeiture for a reasonable, as opposed to an indefinite, period of time.<sup>115</sup> The cases can be distinguished on another ground. In *P.M.G. Corp.*, the trustee sought to restrain a forfeiture provision so that he could evaluate the executory contract.<sup>116</sup> In *Schokbeton Industries*, however, there was no suggestion that the debtor needed time to evaluate the benefit of the license

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110. 466 F.2d 171 (5th Cir. 1972).

111. *Id.* at 174.

112. *Id.*

113. *Id.* at 175 n.7.

114. *Id.* at 177.

115. 520 F.2d at 744.

116. See text accompanying note 106 *supra*.

agreement to the estate. The debtor based its name and its corporate existence on its license of the Schokbeton concrete production process.<sup>117</sup> It appears that in *Schokbeton Industries* the debtor needed time, not to evaluate the license, but to find cash to cover the overdue royalty payment. *Schokbeton Industries*, therefore, holds that the debtor cannot be excused indefinitely from contract performance while it seeks the means to perform.

The Bankruptcy Code does not alter this aspect of *Schokbeton Industries*. That case also noted that the Bankruptcy Act did not allow a unilateral extension of a forfeiture provision.<sup>118</sup> The Code, however, does permit such an extension:

[I]f applicable law . . . or an agreement fixes a period within which the debtor . . . may . . . cure a default . . . and such period has not expired before the date of the filing of the petition, the trustee may . . . cure . . . before the later of—

- (1) the end of such period . . . ; and
- (2) 60 days after the order for relief.<sup>119</sup>

## 2. *The Trustee's Liability for Benefits Received While He Decides Whether to Assume or Reject*

As indicated earlier, the trustee will usually require some time to decide whether to assume or reject an executory contract or unexpired lease.<sup>120</sup> During this time, the trustee will often receive some benefit under the unassumed contract or lease, and the nondebtor may seek to hold the trustee liable for this benefit.<sup>121</sup> Assume, for example, that the debtor leases a clothing store for \$1,000 per month, due on the first of each month. The debtor misses the May rental payment and files for rehabilitation on May 15. The trustee takes some time to evaluate the lease and finally decides to assume it on July 5. Section 365(b) (1) requires the trustee to cure the defaults in rent payments, compensate the lessor for pecuniary losses resulting from the defaults, and provide adequate assurance of future performance.<sup>122</sup> The Code, like the Bankruptcy Act, does not expressly provide for the possibility that the trustee will reject on July 5 after occupying the store for nearly two months. Case law under the Bankruptcy Act established that the lessor could

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117. See 466 F.2d at 174.

118. *Id.* at 175 n.7.

119. Bankruptcy Code § 108(b).

120. See text accompanying notes 97-100 *supra*.

121. In this context, the estate's liability and the trustee's liability are synonymous. The lessor's claim is often said to be for administrative rent.

122. See text accompanying note 50 *supra*.

claim an administrative expense against the estate for the reasonable value of the property occupied by the trustee under the unassumed lease.<sup>123</sup>

In *Reisenweber's v. Irving Trust Co. (In re United Cigar Stores Co.)*,<sup>124</sup> the debtor leased an entire building, operated a cigar store in a corner on the ground floor, sublet the rest of the building, and then filed for rehabilitation. The trustee operated the cigar store and provided some services to and collected some rent from the subtenants. The trustee eventually rejected the lease. The court held the trustee liable, in equity, for the reasonable value of use of the lease and occupation of the cigar store. The trustee was not liable for the reasonable rental value of the entire leased premises, because it had merely tried to maintain the status quo with the subtenants while deciding whether to reject the lease.<sup>125</sup>

Generally, courts will deem the rents called for by the lease reasonable unless some evidence indicates otherwise.<sup>126</sup> The trustee is liable only for a reasonable rental of the premises actually occupied.<sup>127</sup> The weight of authority holds that the trustee is liable for his use and occupancy from the first date of his occupation, not from the first date after bankruptcy that a new installment of rent would have been due under the debtor's lease.<sup>128</sup> The clothing store example set forth above illustrates this proposition. After failing to pay the rent due on May 1, the debtor filed for rehabilitation on May 15, at which time the trustee immediately occupied the leased premises. The majority rule holds the trustee liable for his occupation from May 15. The minority rule holds the trustee liable for his occupation from June 1, when the debtor's next rent payment would have been due.

The cases are also split on the question of whether the

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123. See, e.g., *American Anthracite & Bituminous Coal Corp. v. Leonardo Arrivabene, S.A.*, 280 F.2d 119, 124 (2d Cir. 1960).

124. 69 F.2d 513 (2d Cir.), cert. denied, 293 U.S. 566 (1934).

125. *Id.* at 515. Accord, *In re Unishops, Inc.*, 422 F. Supp. 75, 76 (S.D.N.Y. 1975), *aff'd per curiam*, 543 F.2d 1017 (2d Cir. 1976) ("occupation by a sublessee of a debtor is not to be construed as occupation by the debtor in possession"). Cf. *Lama Co. v. Union Bank*, 315 F.2d 750 (9th Cir. 1963) (holding that the trustee occupied the entire premises when he padlocked and nailed it shut to indicate his possession, even though he had abandoned to a secured creditor two-thirds of the property stored on the premises).

126. See, e.g., *Diversified Servs., Inc. v. Harralson*, 369 F.2d 93, 95 (5th Cir. 1966).

127. See *120 Wall Assocs. v. Schilling*, 266 F.2d 548, 550 (2d Cir. 1959).

128. See, e.g., *id.*; *In re Buttonwood Sec., Inc.*, 349 F. Supp. 273 (S.D. Cal. 1972).

court should consider the trustee's use of the property in setting the reasonable value of the trustee's occupation. In *120 Wall Associates v. Schilling*,<sup>129</sup> for example, the Second Circuit indicated that if the trustee used the debtor's offices for storage, the lessor could recover only the value of the premises as storage space.<sup>130</sup> But in *Diversified Services, Inc. v. Harralson*,<sup>131</sup> the Fifth Circuit stated that the administrative rent due from the trustee should not be affected by the fact that the trustee used premises for storage that had been occupied previously by a going business.<sup>132</sup>

3. *The Trustee's Liability for a Lessor's Furnishing of Services or Supplies Incidental to an Unassumed Lease:*  
*Section 365(b)(4)*

A lessor's common law right to administrative rent provides some compensation for the trustee's use of property under an unassumed lease. Section 365(b)(4) provides an additional, limited right of compensation for affirmative performance by a lessor under an unassumed lease. If there has been a nonfinancial default in an unexpired lease of the debtor, "the trustee may not require a lessor to provide services or supplies incidental to such lease before assumption of such lease unless the lessor is compensated under the terms of such lease for any services and supplies provided under such lease before assumption of such lease."<sup>133</sup>

The meaning of section 365(b)(4) may best be explored with an example. Assume that the debtor leases a small fleet of trucks from *L*. Under the lease, *L* must maintain the trucks in safe operating condition, and the debtor must pay \$1,000 rental on the first day of each month. Assume further that the debtor files a chapter 11 petition on May 29, and the trustee fails to pay the rent due on June 1. On June 5, the trustee demands that *L* repair a truck that just broke down. *L* refuses to service the

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129. 266 F.2d 548 (2d Cir. 1959).

130. *Id.* at 550.

131. 369 F.2d 93 (5th Cir. 1966).

132. *Id.* at 95. The Bankruptcy Code does not directly address the variation in the case law under the Bankruptcy Act on the trustee's liability for benefits received while he decides whether to assume. The automatic stay applies during this period, and the analysis of the Code's requirement of adequate protection for lessors would apply to the issues in these cases. See text accompanying notes 136-147 *infra*. The legislative history, unfortunately, does not indicate Congress' intent in this regard.

133. Bankruptcy Code § 365(b)(4). For a definition of a financial default, see text accompanying note 51 *supra*.



truck unless the trustee first pays the \$1,000 due under the lease on June 1. The trustee can argue that the \$1,000 is not compensation for *services* under the terms of the lease, but rather is the *entire compensation*; therefore, the trustee can argue, he may pay *L* either the component price of service under the lease or the cost to *L* of servicing the truck.

The trustee can support his argument by showing that Congress, in passing section 365(b)(4), did not adopt suggested amendments that would have prohibited the trustee's use of leased property before assumption of the lease.<sup>134</sup> It appears that Congress intended to protect lessors only from *further* losses caused by the trustee's need for incidental services or supplies.<sup>135</sup> A court interpreting 365(b)(4) can provide that protection for lessors by requiring the trustee to pay the lessor's cost of providing incidental services or supplies.

#### 4. *Special Protection for Lessors: Section 363(e)*

Section 363(e) provides that "at any time, on request of an entity that has an interest in property used . . . by the trustee, the court shall prohibit or condition such use . . . as is necessary to provide adequate protection of such interest."<sup>136</sup> This section, although originally intended to protect a secured creditor's interest in collateral used by the trustee,<sup>137</sup> is general enough to apply to a lessor's interest in leased property used by the trustee.

The unenacted predecessors of section 363(e) expressly protected lessors whose property was used by the trustee. The Commission's bill and the Judges' bill<sup>138</sup> both allowed the trustee to use property leased pursuant to an unassumed lease

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134. The counsel for the Car & Truck Renting and Leasing Association wrote to Senator DeConcini urging amendment of section 365 of S. 2266 so that the trustee is not entitled to operate the equipment or demand additional operating supplies under [an unassumed lease] unless and until he shall have either accepted the lease or shall have given the lessor adequate assurance against loss on account of such operation or furnishing of additional supplies and services. In other words, although the benefits of an executory contract are made available to the trustee, he cannot demand performance by the other party until he himself undertakes to perform the assumed obligations or furnishes assurance to the other party against *further* loss and expense.

*Hearings on S. 2266 & H.R. 8200, supra* note 1, at 882, 884 (emphasis added).

135. *See id.*

136. Bankruptcy Code § 363(e).

137. *See* text accompanying note 143 *infra*.

138. *See* note 1 *supra*.

until termination of the automatic stay.<sup>139</sup> Both proposals also allowed the lessor to apply for termination of the stay for lack of adequate protection of the lessor's interest. Upon termination of the stay, the lessor could exercise his right to seize the leased property.

As indicated above, section 363(e) of the Bankruptcy Code protects entities with an interest in property used by the trustee.<sup>140</sup> A lessor has an interest in property that he has leased to the debtor. The definition of that interest will deter-

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139. The Commission's bill provided for use of leased property by the trustee during the automatic stay:

*Section 7-203. Use of Property Leased or Subject to a Lien.*

(a) *Use of Property.* Notwithstanding the terms of a lease of personal property . . . ,

- (1) the trustee . . . may use . . . personal property leased pursuant to a lease that has not been assumed, in the operation of the business of the debtor, until termination of the stay prescribed by section 4-501; . . .

....  
(b) *Relief from or Modification of Stay.* Pursuant to the Rules of Bankruptcy Procedure and section 4-501(c), a secured party or lessor may file a complaint (1) to terminate the stay, or (2) to modify the stay by imposing such conditions on the use of the property or the proceeds thereof as will adequately protect the secured party. The trustee or debtor shall have the burden of proving that the value of the secured creditor's interest in the property or the property leased as of the date of the petition is adequately protected.

Commission's bill, *supra* note 1, reprinted in *Hearings on H.R. 31 & H.R. 32*, *supra* note 1, app., at 242-44. The Judges' bill contained a substantially similar provision:

*Section 4-715. Use of Property Leased or Subject to a Lien.*

(a) *Use of Property.* Notwithstanding the terms of a lease of property or a security agreement, the trustee . . . may, until termination of the stay prescribed by section 4-501, use—

- (1) rents and profits of real estate owned or held under lease by the debtor;
- (2) property leased pursuant to a lease that has not been assumed; and
- (3) property of the estate subject to a lien, other than the proceeds of collateral, and may continue to use the proceeds of collateral upon the filing of an involuntary petition . . . if notice of the filing of the petition is served upon the secured party . . . .

....  
(c) *Relief From or Modification of Stay.* Pursuant to the Rules of Bankruptcy Procedure and section 4-501(c), a secured party or lessor may file a complaint (1) to terminate the stay, or (2) to modify the stay by imposing such conditions on the use of the property or the proceeds thereof as will adequately protect the secured party. The trustee or debtor shall have the burden of proving that the secured creditor's interest in the property or the property leased as of the date of the petition is adequately protected.

Judges' bill, *supra* note 1, reprinted in *Hearings on H.R. 31 & H.R. 32*, *supra* note 1, app., at 242-44.

140. Bankruptcy Code § 363(e), *quoted in text* accompanying note 136 *supra*.

mine what protection section 363(e) affords a lessor whose property the trustee uses before assuming the lease. Once the trustee assumes a lease, section 363(e) should no longer apply; the trustee will be bound by the terms of the lease, and the requirements of section 365 should protect the lessor. Section 363(e) may determine the lessor's rights, however, both while the trustee is deciding whether to assume the lease and if the trustee rejects the lease after some deliberation.

Reconsider the debtor who leased a fleet of trucks for \$1,000 per month, due on the first of each month. When the debtor files under chapter 11 on May 15, the lessor becomes concerned that the trustee will not pay the rent due on June 1. The lessor therefore applies to the court for adequate protection of his interest.<sup>141</sup> The lessor's interest in this situation is twofold. First, he has an interest in the lease itself; *i.e.*, he has a claim for the rental payments due under the lease. Second, he has an interest in the leased property itself; *i.e.*, he holds title to the leased property. The court, in providing adequate protection for the lessor under section 363(e), should consider these interests separately.

When the lessor asserts a right to be paid the full lease rentals under an unassumed lease during the automatic stay,<sup>142</sup> he seeks payments that the debtor has promised him. In this regard, he is similar to any other creditor, and section 363(e) provides him adequate protection of his interest. "Adequate protection of an interest of an entity in property is intended to protect a creditor's allowed *secured claim*."<sup>143</sup> Even though a lessor holds title to the leased property, it is generally only his security deposit that secures his claim for the rent due on that property. The trustee's use of the leased property will not affect the lessor's security deposit. Thus, his use will not adversely affect the lessor's secured claim for the rent due under the lease. The section 363(e) requirement of adequate protection for an entity's interest in property used by the trustee during the automatic stay therefore does not encompass the lessor's interest in receiving the rent due under his lease with the debtor.

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141. The automatic stay in section 362 effectively bars any other action by the lessor. See note 94 *supra* and accompanying text.

142. See note 94 *supra*.

143. Statement of Rep. Edwards, *supra* note 1, at H11092, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6436, 6444 (emphasis added); Statement of Sen. DeConcini, *supra* note 1, at S17409, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6505, 6513 (emphasis added).

The lessor, however, has another interest in the leased property, an interest that section 363(e) does not adequately protect. The lessor holds title to the leased property that the trustee uses under an unassumed lease.<sup>144</sup> Section 361 defines the means by which the court can provide adequate protection of the interest of an entity in property.<sup>145</sup> Section 361(1) seems an appropriate means of protecting a lessor's interests. It calls for periodic cash payments to the lessor to the extent that the trustee's use of the leased property decreases the value of that property. The protection that a court will provide a lessor under section 361(1) will depend on the facts of each case. The lessor of the fleet of trucks in the example should receive payments, not of the lease rentals, but of an amount adequate to cover the decline in value of the trucks during the period in which the trustee uses them.

Section 361(1) also requires payments to the lessor to the extent that the automatic stay under section 362 results in a decrease in the value of the lessor's interest in the leased property. Assume, for example, that the trustee does not use the trucks leased from the lessor while he decides whether to as-

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144. The remarks of legislative leaders indicate that in a "financial" or "security" lease,

the lessor has no substantial interest in the leased property at the expiration of the lease term. . . . The rental payments in such cases are in substance payments of principal and interest either on a loan secured by the leased real property or on the purchase of the leased real property.

Statement of Rep. Edwards, *supra* note 1, at H11094, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6436, 6448-49; Statement of Sen. DeConcini, *supra* note 1, at S17410, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6505, 6517. In a "true" lease, as opposed to a "financial" or "security" lease, the lessor's title has some value at the end of the lease term.

145. Section 361 of the Bankruptcy Code provides:

When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—

- (1) requiring the trustee to make periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;
- (2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease or grant results in a decrease in the value of such entity's interest in such property; or
- (3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

sume the lease. During this period, the lessor will be subject to the automatic stay. The trustee, in taking time to decide whether to assume the lease, is proposing, in effect, a possible future use of the leased property. Section 363(e) therefore allows the lessor to petition the court for protection of its interest in the leased property.

Assume that the trustee takes two months to decide to reject the lease and that during those months the truck's fair market value decreases by \$800. The lessor is entitled to adequate protection in that amount. If the lessor requests adequate protection under section 363(e), and the protection provided by the court proves inadequate, then the lessor should have a section 507(b) "super-priority" to the extent of the inadequacy.<sup>146</sup> In this example, the trustee did not use the leased property while he was deciding to reject the lease. Nonetheless, the property declined in value, and the lessor should recover the amount of that decline if he sought such protection under section 363(e). This alters the common law rule that the trustee is liable only for his actual use of the leased property during the decision period.<sup>147</sup>

#### B. CONTRACTS AND LEASES THAT THE TRUSTEE HAS ASSUMED

"The trustee . . . may not blow hot and cold. If he accepts the contract, he accepts it *cum onere*. If he receives the benefits he must adopt the burdens. He cannot accept one and reject the other."<sup>148</sup> After assuming a contract or lease, the trustee must perform in full, as the debtor would have been bound to perform had bankruptcy not intervened.<sup>149</sup> Moreover, the nonbankrupt party's claim for performance is a cost of preserving the estate entitled to a section 507(a)(1) priority as an administrative expense.<sup>150</sup>

The general proposition that the terms of an assumed executory contract or unexpired lease bind the trustee is subject to

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146. Section 507(b) of the Bankruptcy Code states:

If the trustee, under section 362, 363, or 364 of this title, provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim . . . arising from the stay of action [or, *inter alia*, use under section 363], then such creditor's claim . . . shall have priority over every other claim . . .

147. See text accompanying notes 120-132 *supra*.

148. *In re Italian Cook Oil Corp.*, 190 F.2d 994, 997 (3d Cir. 1951).

149. See *Vilas & Sommer, Inc. v. Mahony (In re Steelship Corp.)*, 576 F.2d 128, 132 (8th Cir. 1978).

150. See *American Anthracite & Bituminous Coal Corp. v. Leonardo Arivabene, S.A.*, 280 F.2d 119, 124 (2d Cir. 1960).

three exceptions. First, section 108(b) may extend the time that the trustee has to cure a default.<sup>151</sup> Second, default clauses do not bind the trustee when he takes a reasonable time to decide whether to assume.<sup>152</sup> Finally, section 365(e) invalidates provisions that modify contract or lease rights because of the debtor's financial condition or the commencement of a bankruptcy case.<sup>153</sup>

### C. CONTRACTS AND LEASES THAT THE TRUSTEE HAS REJECTED

Section 365(g) states that "the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease."<sup>154</sup> It does not, however, apply to real property leases in which the debtor is the lessor, or to installment land sale contracts in which the nondebtor-vendee is in possession. Sections 365(h) and (i), discussed in part IV of this Article, govern these leases and contracts.

"The purpose [of section 365(g)] is to treat rejection claim[s] as prepetition claims."<sup>155</sup> Under section 365(g)(1), the breach arising from the trustee's rejection of an executory contract or unexpired lease that has never been assumed occurs immediately before the filing of the petition. Section 502(g) provides that:

A claim arising from the rejection . . . of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under . . . this section or disallowed under . . . this section, the same as if such claim had arisen before the date of the filing of the petition.<sup>156</sup>

Under section 502(a), any claim filed under section 501 is deemed allowed unless an interested party objects. Section 502(b) requires the court to determine the amount of a claim to which an objection is made; it also requires disallowance of some claims or portions of claims on a variety of grounds.<sup>157</sup>

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151. See Bankruptcy Code § 108(b), *quoted in text* accompanying note 119 *supra*.

152. See text accompanying notes 105-117 *supra*.

153. See text accompanying note 27 *supra*.

154. Bankruptcy Code § 365(g).

155. H.R. REP. NO. 595, *supra* note 1, at 349, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6305; S. REP. NO. 989, *supra* note 1, at 60, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5846.

156. Bankruptcy Code § 502(g).

157. Section 502(b) of the Bankruptcy Code provides:

Except as provided in subsections (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—

(1) such claim is unenforceable against the debtor, and unen-

Under section 502(b)(1), for example, the trustee can have the court disallow a claim for rejection of an executory contract that could not have been enforced against the debtor. Section 502(b)(8) limits claims for termination of an employment contract. Section 502(b)(7) limits the allowability of a real property lessor's claim for termination of his lease.<sup>158</sup> Congress "designed [section 502(b)(7)] to compensate the landlord for his loss while not permitting a claim so large . . . as to prevent other general unsecured creditors from recovering a dividend from the estate."<sup>159</sup>

In a chapter 11 or 13 case, and in a chapter 7 case that has not been converted from another chapter, if the trustee rejects or breaches a contract that he has assumed, the breach occurs

forceable against property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured;

(7) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—

(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—

(i) the date of the filing of the petition; and

(ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates;

(8) if such claim is for damages resulting from the termination of an employment contract, such claim exceeds—

(A) the compensation provided by such contract, without acceleration, for one year following the earlier of—

(i) the date of the filing of the petition; and

(ii) the date on which the employer directed the employee to terminate, or such employee terminated, performance under such contract; plus

(B) the unpaid compensation due under such contract without acceleration, on the earlier of such dates; . . .

158. Assume that *L* has let premises to the debtor for \$1,000 per month under a 25-year lease. The debtor misses two months' rent and files for bankruptcy when 24 years remain on the lease. The trustee rejects the lease immediately. Section 502(b)(7) places a ceiling on *L*'s claim in bankruptcy equal to (a) three years' remaining rent or \$36,000, plus (b) \$2,000. This, however, does not mean that *L* has a claim against the estate for \$38,000. *L* has a claim only for his actual damages from the breach of the lease, up to a maximum of \$38,000.

The section 502(b)(7) limit on a lessor's damages applies only to "true" as opposed to "financial" leases. Statement of Sen. DeConcini, *supra* note 1, at S17410, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6505, 6517; Statement of Rep. Edwards, *supra* note 1, at H11094, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6436, 6448. For a definition of "true" and "financial" leases, see note 144 *supra*.

159. H.R. REP. NO. 595, *supra* note 1, at 353, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6309; S. REP. NO. 989, *supra* note 1, at 63, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5849. See also note 164 *infra*.

at the time of rejection.<sup>160</sup> In such an instance the nonbankrupt party will have an administrative expense claim for the breach under section 507(a)(1).<sup>161</sup>

Section 726 of the Bankruptcy Code governs the distribution of the property of the estate in liquidation. It grants priority to claims under section 507 in the order of their listing in that section, then to allowed unsecured claims. Section 507(a)(1) grants a first-level priority to administrative expense claims such as those arising from the breach of an executory contract or unexpired lease that the trustee has assumed.<sup>162</sup> Section 507(a)(5) establishes a fifth-level priority for claims up to \$900 "arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided."<sup>163</sup> Assume, for example, that a consumer places a \$200 deposit on a washing machine at an appliance store. The store subsequently files for bankruptcy, and the trustee rejects the executory sales contract with the consumer. The consumer then has only an unsecured prepetition claim against the estate for his deposit, but section 507(a)(5) gives that claim priority.<sup>164</sup>

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160. Bankruptcy Code § 365(g)(2)(A). If the trustee assumes an executory contract or unexpired lease in a chapter 11 or 13 case that is later converted to a chapter 7 liquidation case, and the trustee, after conversion, rejects the contract or lease, the breach occurs immediately before the conversion. Bankruptcy Code § 365(g)(2)(B)(i). Liability for breach of a contract assumed in a chapter 11 or 13 case is an expense under those chapters even if the breach does not occur until after the conversion of the case to liquidation. *See* J. TROST, C. KING & K. KLEE, *THE PROPOSED FEDERAL BANKRUPTCY REFORM ACT 157* (1978). Section 726(b) gives priority to the administrative expenses of liquidation over the administrative expenses of the associated preconversion chapter 11 or 13 case. If, after conversion, the trustee assumes an executory contract or unexpired lease and later rejects it, the breach occurs at the time of rejection. Bankruptcy Code § 365(g)(2)(B)(ii). Damages from the breach will then be an administrative expense of liquidation.

161. *See* 2 COLLIER ON BANKRUPTCY ¶ 365.03 (15th ed. 1979).

162. *See* text accompanying note 161 *supra*.

163. Bankruptcy Code § 507(a)(5).

164. *Compare* Act of June 22, 1938, ch. 575, § 64(a)(5), 52 Stat. 840 (repealed 1978) (Bankruptcy Act) (granting landlords a priority for their rent claims) *with* Bankruptcy Code § 507(b)(7) (granting no such priority). *See also* text accompanying note 159 *supra*.



#### IV. SPECIAL TREATMENT OF CERTAIN REAL PROPERTY LEASES AND INSTALLMENT LAND SALE CONTRACTS

##### A. REAL PROPERTY LEASES IN WHICH THE DEBTOR IS THE LANDLORD

Section 365(a) expressly limits the trustee's power to reject executory contracts and unexpired leases only by making the trustee's rejection "subject to the court's approval." Section 365(h), however, *may* limit the trustee's power to reject real property leases in which the debtor is the landlord.<sup>165</sup> This section can be best understood by first examining the law under the Bankruptcy Act.

Section 70(b) of the Bankruptcy Act provided, "Unless a lease of real property shall expressly otherwise provide, a rejection of such lease or of any covenant therein by the trustee of the lessor shall not *deprive the lessee of his estate*."<sup>166</sup> The courts occasionally had difficulty interpreting this section. Consider, for example, the comment on section 70(b) in *In re Penn Central Transportation Co.*<sup>167</sup>

One theory, which has many adherents among the commentators, is that the lessee's "estate" which is protected is his right of possession, together with all covenants running with the land in his favor. Implementation of that theory may involve difficult questions as to what covenants do run with the land, and by what law those issues are to be decided. Does state law control, does state law control unless it is aberrational and contrary to the goals of federal bankruptcy law, or does federal bankruptcy law control entirely?<sup>168</sup>

In *In re Penn Central Transportation Co.*, the trustees for the bankrupt lessor attempted to disaffirm the lessees' obligations to pay the rents specified in their leases. The trustees then wanted to set the rents at current market value and evict the lessees if they failed to pay the increased rents. The trustees argued that the evictions would be based on breaches of the modified rental obligations, not on the trustees' disaffirmance.<sup>169</sup> The court commented, "Whether an obligation due to

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165. Section 365(i) of the Bankruptcy Code, which provides to installment land sale vendees in possession protection similar to that which section 365(h) provides real property lessees, may limit the trustee's power to reject such contracts. See text accompanying notes 184-190 *infra*.

166. Act of June 22, 1938, ch. 575, § 70(b), 52 Stat. 840 (repealed 1978) (emphasis added).

167. 458 F. Supp. 1346 (E.D. Pa. 1978).

168. *Id.* at 1355. See also Creedon & Zinman, *Landlord's Bankruptcy: Laissez les Lessees*, 26 BUS. LAW. 1391, 1434 (1971); Kane & Ruttenberg, *The Landlord-Tenant Relationship in Bankruptcy*, 12 REAL PROP., PROB. & TR. J. 482, 496 (1977).

169. 458 F. Supp. at 1355.

the Debtor [in this case, rental payments] may be disaffirmed is an issue which is not definitively resolved by the cases."<sup>170</sup> The court did not expressly hold that the lessees' estate included the right to possession at the rent specified in the lease. Instead, the court stated that equitable considerations precluded the trustees' disaffirmance of the leases and renegotiation of the rentals:

The lessees are not creditors of the estate, who extended credit and took the risks of such extensions. There are no burdensome affirmative covenants. The leases were negotiated at arms length; if they are less attractive now than they might be, the difference is attributable solely to changes in the economic climate and not to the Debtor's financial reverses.<sup>171</sup>

The Commission on the Bankruptcy Laws stated that the definition of the lessee's estate "remains unclear in the absence of dispositive judicial construction."<sup>172</sup> The Commission proposed to resolve the uncertainties in the old law by providing in its bill that "the rejection of a lease under which the debtor is the lessor constitutes the abandonment of the leased property to the lessee and not a breach of the lease."<sup>173</sup> The Commission indicated that the trustee could reject any covenant of the lease, and the lessee would have no claim against the estate.<sup>174</sup> The Commission's abandonment approach, however, raised additional questions. Would, for example, abandonment be a conveyance to the lessee?<sup>175</sup>

The Judges' bill adopted different and more specific language in response to the problem of defining the lessee's estate:

[T]he rejection of a lease under which the debtor is the lessor shall give the lessee the option of continuing the occupancy of the leased premises or possession of the leased property, as the case may be, upon the lessee's payment of the rentals stipulated by the lease agreement to the successor to debtor's interest as lessor; lessee shall have the further option of performing lessor's defaulted obligations at lessee's costs and to receive offset credit for those costs against lessee's stipulated rental payments.<sup>176</sup>

This rejection of the abandonment approach avoids some of the

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170. *Id.* at 1355 n.7.

171. *Id.* at 1356.

172. BANKRUPTCY COMMISSION REPORT, *supra* note 1, pt. II, at 157.

173. Commission's bill, *supra* note 1, reprinted in *Hearings on H.R. 31 & H.R. 32*, *supra* note 1, app. § 4-602(c), at 168.

174. See BANKRUPTCY COMMISSION REPORT, *supra* note 1, pt. II, at 157 (Section 4-602(c) "obviates the need to distinguish between leased covenants that are part of the 'estate' of the lease and those that are not . . . [T]he lessee receiving the abandoned property is not permitted a claim for loss of bargain.").

175. See *Hearings on H.R. 31 & H.R. 32*, *supra* note 1, pt. III, at 1596-97.

176. Judges' bill, *supra* note 1, reprinted in *Hearings on H.R. 31 & H.R. 32*, *supra* note 1, app. § 4-602(c), at 168.

problems of the Commission's bill. But the Judges' bill, by providing that rejection "*shall* give the lessee the option of continuing . . . possession of the leased property," raised the question whether the trustee could reject every lease covenant. For example, assume that the lease for the fourteenth floor of an office building provides that the lessor has to furnish elevator service. The lessee could claim under the Judges' bill that the trustee could not reject the covenant to provide elevator service because such a rejection would effectively deny the lessee his option of continuing possession.<sup>177</sup>

This problem carries over into the Code.<sup>178</sup> Section 365(h) provides:

(1) If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, the lessee under such lease may treat the lease as terminated by such rejection, or, in the alternative, may remain in possession for the balance of the term of such lease and any renewal or extension of such term that is enforceable by such lessee under applicable nonbankruptcy law.

(2) If such lessee remains in possession, such lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease, and any such renewal or extension, any damages occurring after such date caused by the non-performance of any obligation of the debtor after such date, but such lessee does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset.<sup>179</sup>

In many cases, the application of section 365(h) will be straightforward. The trustee of the bankrupt lessor will first

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177. Cf. Creedon & Zinman, *supra* note 168, at 1407 n.64 (suggesting that cutting off the heat to a leased fiftieth floor office "might so affect or impair the lessee's right to possession that it might be considered a deprivation of his estate" within the meaning of section 70(b) of the Bankruptcy Act).

178. Judge Fullam, however, did not foresee any difficulties in applying section 365(h):

The House has recently passed H.R. 8200, which is a complete revision of the Bankruptcy Act. Section 365(h) of that bill provides that the lessor may reject, but the lessee may not be deprived of possession. The only remedy of the lessee is to terminate the lease or remain in possession and offset damages arising from rejection against post-rejection rentals. No matter how one views the line drawn in § 365(h), the section has the advantage of bringing clarity to an area of bankruptcy practice sorely in need of clarification.

*In re* Penn Cent. Transp. Co., 458 F. Supp. 1346, 1356 n.10 (E.D. Pa. 1978).

Some, however, thought that section 70(b) of the Bankruptcy Act clarified the trustee's power to reject leases. "[T]he rights and duties of a trustee with respect to the rejection of . . . unexpired leases of real property . . . have been specified and clearly defined [in section 70(b)]." Chandler, *The Revised Bankruptcy Act of 1938*, 24 A.B.A.J. 880, 882 (1938). See Creedon & Zinman, *supra* note 168, at 1399 n.36 (quoting this sentence and remarking that it was "the most optimistic statement of the year"). Judge Fullam's optimistic statement may well be proven accurate.

179. Bankruptcy Code § 365(h).

decide whether the lease is burdensome. If it is, he will reject. The lessee can then treat the lease as terminated and abandon the premises without any liability. The lessee also has the option to continue occupation of the leased premises for the balance of the lease term. Because the trustee has rejected the lease, he will no longer perform the services that the lease required of him. The tenant can perform these services himself and deduct the cost from the rent due the trustee.

The following example illustrates several applications of section 365(h). Assume that a lessee rents a warehouse from the debtor for \$1,000 per month, and the lease provides that the debtor shall maintain the exterior of the building and heat the interior. The debtor files for bankruptcy, and the trustee rejects the lease. The lessee can then treat the lease as terminated and move out without any liability to the estate. Alternatively, the lessee can remain in possession and offset the cost of maintaining the exterior of the warehouse and heating the interior from the \$1,000 per month rent due the estate. Assume that the lessee elects to remain in possession and spends \$100 per month to heat the building. The lessee must then pay the estate \$900 per month. The lessee's treatment is somewhat akin to that accorded a nonbankrupt party whose executory contract the trustee assumes and later breaches. Such a nonbankrupt party receives an administrative expense claim for damages from the breach and has some chance of recovering most or all of his damages from the estate.<sup>180</sup> The lessee recovers all of his damages from the breach of the lease through the offset, not as an administrative expense, but as if he had a fully secured claim.

Now assume that the lessee must spend \$9,000 to fix the roof and paint the exterior of the warehouse. The trustee's rejection damaged the lessee in the amount of \$9,000, and the lessee can offset that amount from the rent due under the lease. The rent due is \$900 per month, after the heat offset, so the lessee does not have to pay the estate any rent for ten months. At the end of ten months, the lessee's damages will have been fully offset and the lessee will have to resume paying \$900 per month to the estate.

Section 365(h) clearly provides for all situations in which the damages to the lessee from the trustee's rejection are less than the rent due under the remaining term of the lease. Assume, however, that the warehouse roof caves in just before

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180. See text accompanying note 162 *supra*.

bankruptcy. The lessee would have to spend \$90,000 to repair the roof, and only five years remain on the lease term. The offset of five years' rent will not fully compensate the lessee for his damages from the trustee's rejection.

The lessee can argue that the trustee cannot reject the lease and the obligation under it to maintain the exterior of the building, because to do so would effectively deny the lessee his option to remain in possession of the leased premises. Section 365(h) indicates that Congress intended that the trustee's rejection would not deprive the lessee of his alternative to remain in possession. Furthermore, the legislative history indicates that Congress thought section 365(h) would not deprive the lessee "of his estate for the term for which he bargained."<sup>181</sup> The trustee's failure to repair the roof would amount to a constructive eviction that would deprive the lessee of his estate.

The trustee has two arguments to support his position that he can reject the lease obligation to repair the roof. First, repairing the roof is exactly the sort of burdensome obligation the trustee must be able to reject so as not to squander the resources of the estate for the benefit of a single lessee to the detriment of all the creditors.<sup>182</sup> Second, section 365(h) (2) states that the lessee has no rights against the estate, such as a right to compel specific performance of a lease covenant, for *any* damages from the nonperformance of *any* obligation of the debtor under the lease, other than the right to an offset.<sup>183</sup> The trustee's position is stronger in this example. Thus, in at least some situations, section 365(h) allows the trustee to reject any covenant, regardless of the effect that rejection will have on the lessee's estate.

But suppose that the debtor owns and operates a number of office buildings. Most of these buildings have been unprofitable, so the debtor files for rehabilitation. One of the debtor's buildings, however, has been profitable. It has thirty floors occupied by a variety of tenants. In order to acquire a prestigious first tenant that would attract other tenants to the building, the debtor leased the top floor to a law firm at a very favorable rate

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181. H.R. REP. NO. 595, *supra* note 1, at 349, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6306; S. REP. NO. 989, *supra* note 1, at 60, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5846.

182. See Creedon & Zinman, *supra* note 168, at 1406 ("Professor MacLachlan, the major drafter of [section 70(b) of the Bankruptcy Act], said: 'The rejection that I contemplate is the rejection of covenants to repair or build [that are] beyond the capacity of an insolvent and which should not be performed at the expense of his creditors simply because they relate to real estate.'").

183. See text accompanying note 179 *supra*.

of \$9.00 per square foot. The other tenants pay \$15.00 per square foot, and the trustee would like to lease the top floor for that amount. All the leases in the building require the lessor to maintain and operate the elevators. The trustee has asked the law firm to renegotiate its lease. He threatens to reject the lease and keep the firm from using the building's elevators if the firm does not agree to pay an increased rental. Section 365(h) does not protect the lessee in this situation if it is interpreted to allow the trustee to reject any lease obligation. Realistically, the law firm cannot occupy the building if the trustee will not allow it to use the elevators. The right to offset damages here means only that the firm will have to pay nothing for inaccessible offices on the thirtieth floor.

It would be unfortunate if the simple interpretation of section 365(h) discussed above were complicated by limiting the trustee's power to reject to those cases in which the lessee would not effectively be deprived of possession by rejection. Conveniently, a court would not have to vary the simple interpretation of section 365(h) to protect the law firm in this case. The court could protect the lessee from the trustee's inequitable rejection by withholding its approval of that rejection. The trustee seeks rejection here not to relieve the estate of a burdensome obligation, but to coerce the lessee into agreeing to different lease terms. Section 365(a) conditions any rejection on the court's approval, and the improper purpose of the trustee's rejection should compel a court of equity to withhold its approval.

#### B. INSTALLMENT LAND SALE CONTRACTS IN WHICH THE NONDEBTOR BUYER IS IN POSSESSION

Large scale land developers, especially those who offer property by mail, frequently use installment contracts to sell homes to low- and middle-income consumers. Typically, installment land sale contracts require the vendor to deliver title to the vendee only after the vendee has made all the contract payments.<sup>184</sup> An installment land sale contract is executory when the vendor has not delivered title and the vendee has not made all the installment payments.<sup>185</sup> Under the Bankruptcy Act, if the vendor went bankrupt while the contract was executory, the trustee might have tried to reject so that he could take

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184. See generally Note, *Bankruptcy and the Land Sale Contract*, 23 CASE W.L. REV. 393 (1972).

185. See text accompanying notes 9-12 *supra*.

unencumbered title to the property and leave the installment buyer with an unsecured claim for the payments already made. In such a situation, some courts protected the vendee by requiring the trustee to specifically perform the contract.<sup>186</sup> Other courts, however, allowed the trustee to reject, and did not protect the vendee.<sup>187</sup>

Section 365(i) of the Bankruptcy Code<sup>188</sup> provides an installment land sale vendee in possession the same protection from the trustee's rejection that section 365(h) affords a real property lessee.<sup>189</sup> Consider a person who purchases his house from a builder under an installment contract providing for payment of \$600 per month for twenty years. At the end of the twenty years, the contract obligates the builder to deliver title to the purchaser. Assume that three years after the buyer moved in and began his payments, the builder goes bankrupt. The trustee evaluates the contract, finds it burdensome, and rejects it. The buyer has the option to remain in possession. If he elects that option, he must make the payments called for by the contract, less any offset for damages that occur after the date of rejection and that are caused by the builder's nonperformance of any obligation. If the buyer remains in possession, he has no rights against the estate for damages other than the

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186. See, e.g., *England v. Santa Barbara Sav. & Loan (In re Morris Home Dev. Co.)*, 4 Bnkr. Ct. Dec. 837 (N.D. Cal. 1978). See generally Lynn, *Bankruptcy and the Land Sales Contract: The Rights of the Vendee Vis-A-Vis the Vendor's Bankruptcy Trustee*, 5 TEX. TECH L. REV. 677, 687-94 (1974); Note, *supra* note 184.

187. See, e.g., *In re New York Inv. Mut. Group*, 143 F. Supp. 51, 54 (S.D.N.Y. 1956).

188. Section 365(i) of the Bankruptcy Code provides:

(1) If the trustee rejects an executory contract of the debtor for the sale of real property under which the purchaser is in possession, such purchaser may treat such contract as terminated, or, in the alternative, may remain in possession of such real property.

(2) If such purchaser remains in possession—

(A) such purchaser shall continue to make all payments due under such contract, but may, offset against such payments any damages occurring after the date of the rejection of such contract caused by the nonperformance of any obligation of the debtor after such date, but such purchaser does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset; and

(B) the trustee shall deliver title to such purchaser in accordance with the provisions of such contract, but is relieved of all other obligations to perform under such contract.

189. See H.R. REP. NO. 595, *supra* note 1, at 349, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963, 6306; S. REP. NO. 989, *supra* note 1, at 60, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5787, 5846. For a discussion of the protection that section 365(h) provides to a lessee of real property, see text accompanying notes 165-183 *supra*.

offset; the trustee, however, must deliver title to the buyer in accordance with the contract. The trustee has no obligations under the rejected contract other than delivering title.<sup>190</sup>

Upon the trustee's rejection, the buyer also has the option of treating the contract as terminated. In that case, section 365(j) grants the buyer "a lien on the interest of the debtor in [the] property for the recovery of any portion of the purchase price that [the buyer] has paid."<sup>191</sup> If, before bankruptcy, the buyer had not entered into possession of the property that he had purchased under an installment contract, he would not have a right, after rejection, to enter into possession and offset his damages for the payments due under the contract. Section 365(j), however, grants a buyer not in possession a lien on the property to secure the payments made under the contract.<sup>192</sup> The lien granted by section 365(j) protects the buyer under a rejected contract from being left with only a general unsecured claim against the estate for the payments he made under the contract before rejection.

## V. CONCLUSION

The changes in bankruptcy law instituted by the Bankruptcy Code promote treatment of executory contracts and unexpired leases consistent with the law's treatment of other property. The Code generally treats the debtor's rights in executory contracts and unexpired leases as another form of property that passes to the trustee upon bankruptcy. A prebankruptcy termination of a contract or lease is therefore treated the same as a prebankruptcy transfer of other property of the debtor. The Code's invalidation of bankruptcy clauses prevents any termination of contracts or leases upon bankruptcy. Similarly, the Code prevents transfer of other property of the debtor upon bankruptcy.<sup>193</sup> Just as the Code, through the invalidation of restrictions on assignment, allows the trustee to transfer the debtor's rights under executory con-

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190. See Bankruptcy Code § 365(i)(2)(B).

191. Bankruptcy Code § 365(j). This section provides:

A purchaser that treats an executory contract as terminated under subsection (i) of this section or a party whose executory contract to purchase real property from the debtor is rejected and under which such party is not in possession, has a lien on the interest of the debtor in such property for the recovery of any portion of the purchase price that such purchaser or party has paid.

*Id.*

192. *Id.*

193. *Id.* § 547.



tracts and unexpired leases, the Code permits the trustee to transfer the debtor's rights in other property. Finally, the Code allows the trustee for a landlord debtor to shed burdensome lease obligations, just as it allows the trustee to abandon burdensome property.<sup>194</sup>

Executory contracts and unexpired leases differ from other property of the estate in that they involve an ongoing relationship between the trustee or his assignee and the nondebtor. The Code generally treats the debtor's rights in executory contracts and unexpired leases as another form of property, but it makes several exceptions to this rule in recognition of the ongoing relationship with the nondebtor. These exceptions protect the nondebtor's right to get the benefit of his bargain with the debtor through his relationship with the trustee or his assignee. The Code's prohibition of the trustee's assumption of nondelegable contracts and leases without the nondebtor's consent allows the nondebtor himself to determine whether the trustee will perform adequately. In contracts and leases in which there has been a default, the Code requires the trustee, if he wishes to assume, to cure the default and provide adequate assurance of future performance. This directs the court to ensure that the trustee provides the nondebtor with the benefit of his bargain. If the trustee wishes to assign a contract or lease, even if there has not been a default, he must still convince the court that the nondebtor will get the benefit of his bargain. The Code, in short, attempts to strike a balance between two sometimes competing considerations: the right of a nondebtor to get the performance for which he bargained; and the right of the general creditors to get the benefit, through the trustee, of the debtor's bargain.

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194. *Id.* § 554.